The context and purpose of financial reporting

The scope and purpose of financial statements for external repo

Recording, analysing and summarising financial data

Financial reporting is a way or recording, analyzing and summarizing financial data.

Transactions are recorded in books of prime entry. The totals of these books of prime entry are posted to the ledger accounts. Finally, transactions are summarized in the financial statements

Types of business entities

Businesses exist to make a profit. There are three main types of business entity

1. Sole Traders

Sole traders are people who work for themselves. Examples include a hairdresser, the local stationer, a plumber.

A sole trader has unlimited liability, i.e. if the business runs up debts that it is unable to pay, the proprietor will become personally liable for the unpaid debts and would be required, if necessary, to sell his private possessions to repay them. For example, if a sole trader has some capital in his business, but the business now owes $50,000 which it cannot repay, the trader might have to sell his house to raise the money to pay off his business debts.

2. Partnerships

Partnerships occur when two or more people decide to run a business together. Examples include an accountancy practice, a legal practice and a medical practice.

In general, the partners have unlimited liability although there may be circumstances when one or more partners have limited liability.

3. Limited Liability Companies

Limited liability companies are incorporated to take advantage of 'limited liability' for their owners (shareholders).This means that the maximum amount that an owner stands to lose in the event that the company becomes insolvent and cannot pay off his debts, is his share of the capital in the business.

In all cases, we apply the **separate entity concept**, i.e. the business is regarded as being separate from the owner (or owners) and the accounts are prepared for the business itself.

The legal differences

The legal differences between a sole trader, partnership and a limited liability company

In law, sole traders and partnerships are not separate entities from their owners. A partnership ceases and a new one starts whenever a partner joins or leaves the partnership.

A limited liability company has a separate legal identity from its shareholders. In fact, it can issue contracts in the company's name. It continues to exist regardless of the identity of its owners.

Advantages and disadvantages of operating

Advantages of a Limited Company

Limited Liability

More capital can be raised as no limit on number of shareholders

Control of company can not be lost to outsiders – shares only sold if all shareholders agree

The business will continue even if one of the owners dies, shares being transferred to another owner – separate legal identity

Disadvantages of a Limited Company

Profits have to be shared out amongst a potentially larger number of people

Detailed legal procedures must be followed to set up the business – consuming time and money

Financial statements have to comply with legal and accounting requirements

Financial information can be inspected by any member of the public once filed with the Registrar, including competitors

Advantages and Disadvantages of the Sole Trader

Personal satisfaction

Secrecy

Personal Control

Enjoyment of all profits

Absence of legal formalities when establishing business

Financial advantages in terms of low taxes, longer period to pay taxes and lower accountancy fees.

Disadvantages of the Sole Trader

Limited sources of finance

Restricted growth

Full personal responsibility for the decisions and due to unlimited liability the debts of the business

Advantages of a Partnership

There are no legal formalities to complete when setting up the business

Each partner can specialize

Partners can share the workload

Financial advantages in terms of low taxes, longer period to pay taxes and lower accountancy fees.

Disadvantages of a Partnership

Partners are jointly and severely liable for the acts and omissions of the other partners

Profits have to be shared amongst more owners

Partners may disagree

The size of a partnership is limited to a maximum of 20 partners, however there are exceptions to this general rule

Any decision made by one partner on behalf of the company is legally binding on all other partners

Partnerships are unincorporated, resulting in unlimited liability for the partners, making them personally liable for the debts of the firm.

Nature, principles and scope of financial reporting

Financial accounting is mainly a method of reporting the results and financial position of a business. It is not primarily concerned with providing information towards the more efficient running of the business. In fact, financial accounting provides historical (past) information.

Management need to plan for the future. They require detailed information as they are responsible to plan and control the resources of the business. Management (or cost) accounting analyses data to provide information as a basis for managerial action.

action

Users' and stakeholders' needs

The users of financial statements

Why do businesses need to prepare and produce financial information?

A business should produce information about its activities because there are various groups of people who want or need to know that information.

The "Framework for the Preparation and Presentation of Financial Statements" states that, "the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions."

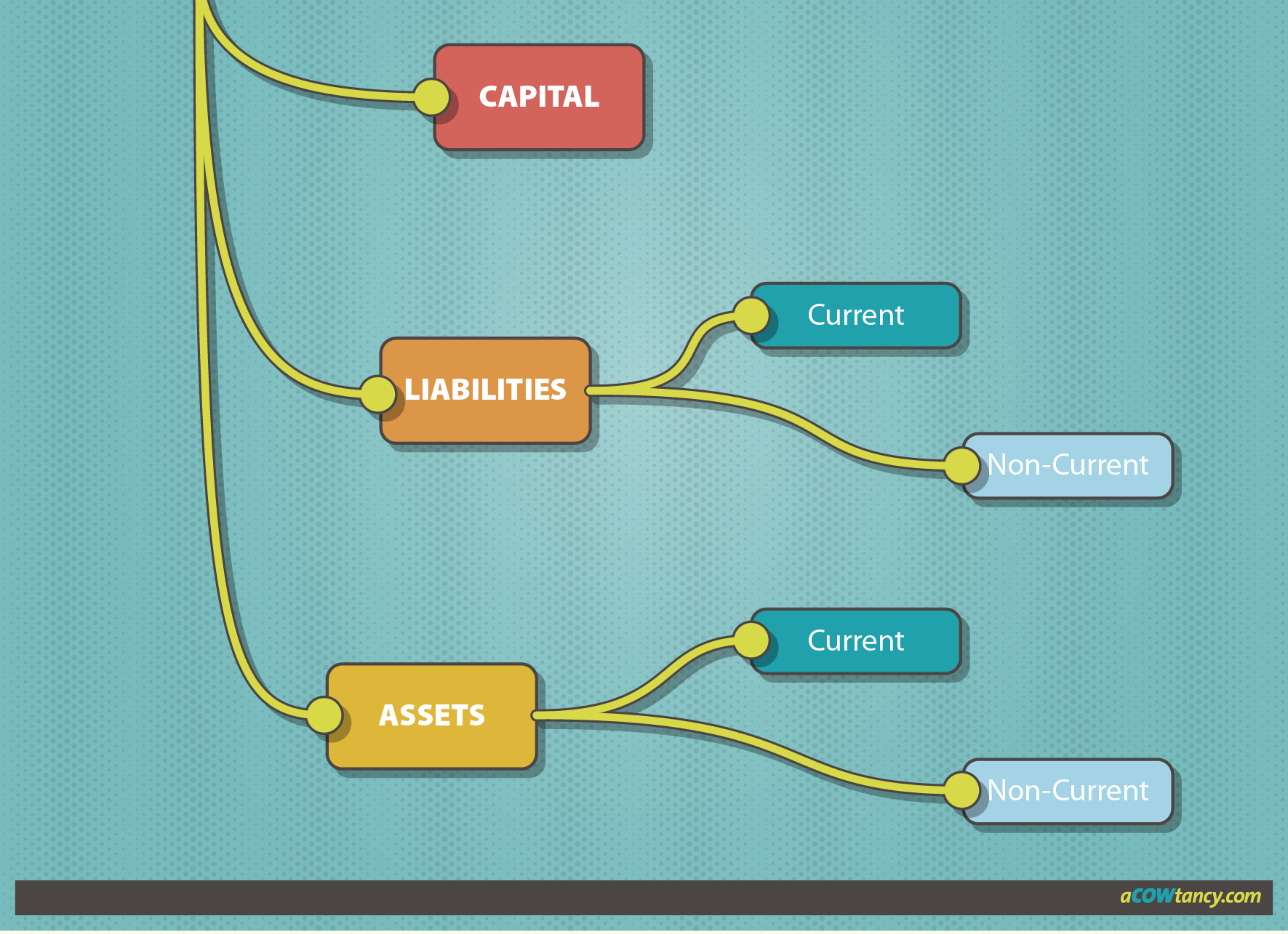
The main elements of financial reports

The main financial statements

The principle financial statements of a sole trader are the statement of financial position and the statement of profit or loss.

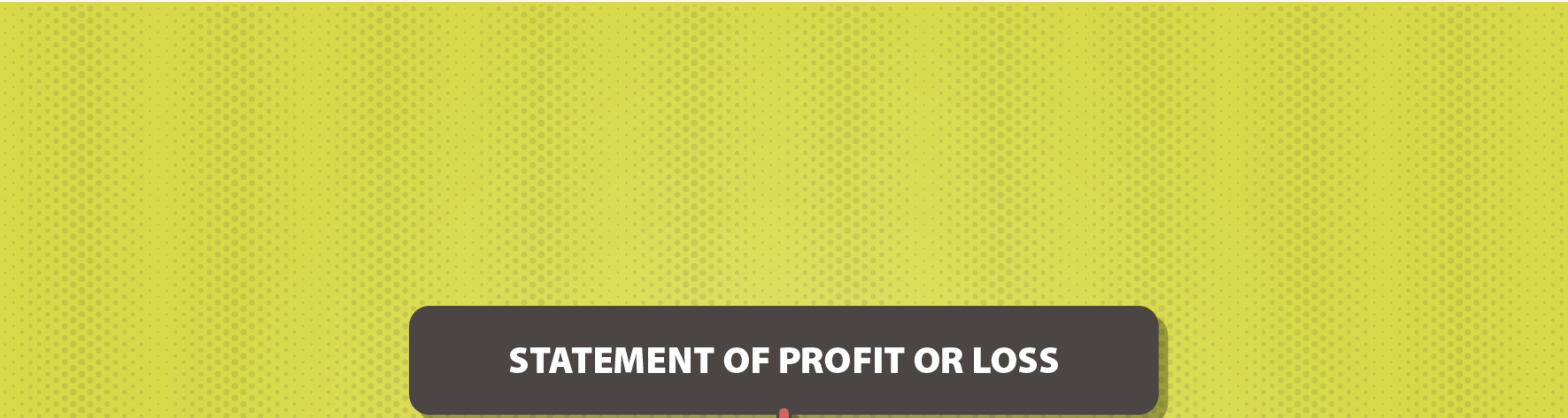
Statement of Financial Position

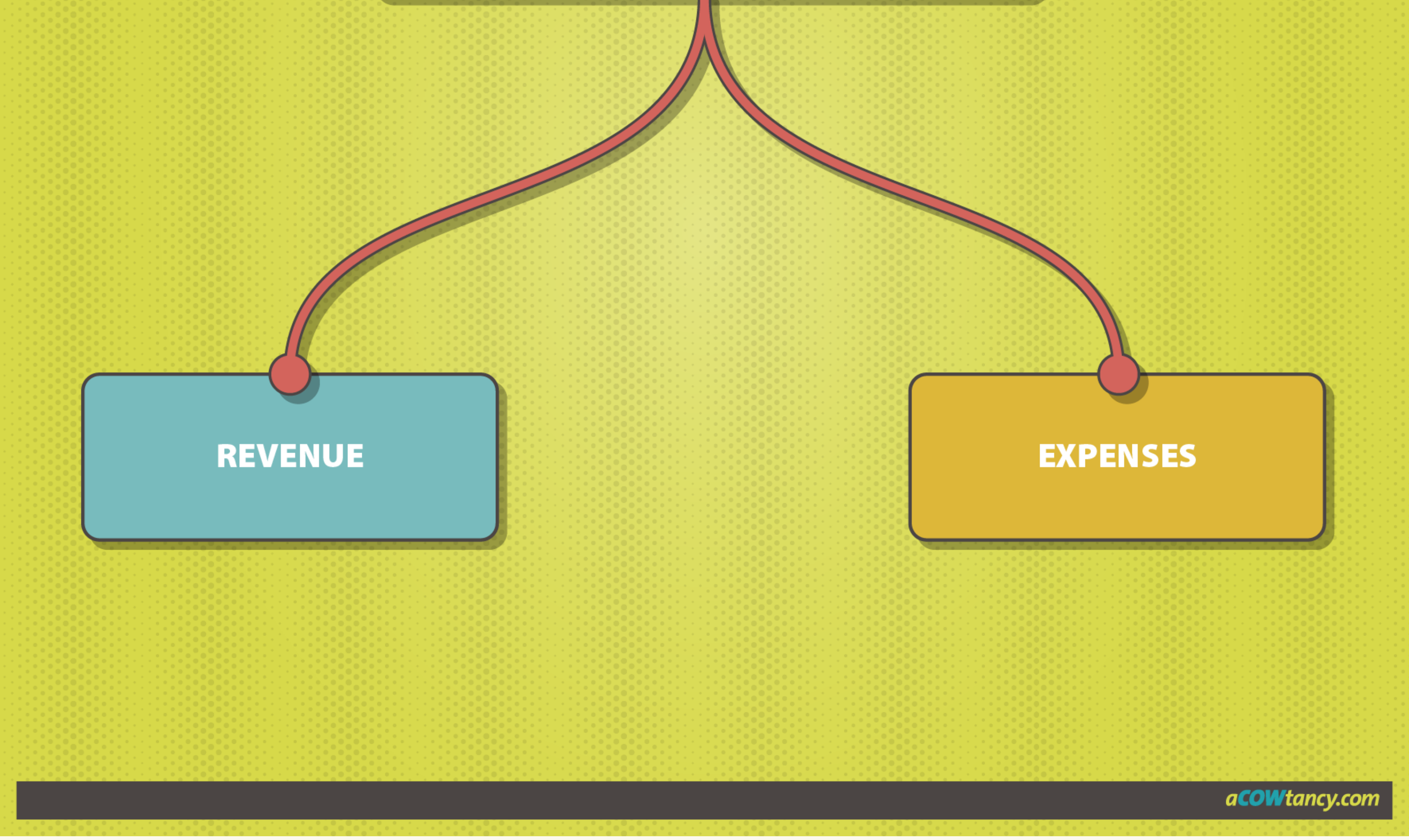
The statement of financial position is a list of all the assets owned and the liabilities owed by a business as at a particular date. It is a snapshot of the financial position of the business at a particular moment.



Statement of profit or loss

A statement of profit or loss is a record of revenue generated and expenditure incurred over a given period. The statement shows whether the business has had more revenue than expenditure (a profit) or vice-versa (a loss)





Notes

1. The top part of the statement of profit or loss, i.e. Sales – Cost of Sales = Gross Profit, is called the Trading Account. It records the trading activities of the business.
2. Sundry income includes bank interest, rent receivable, income from investments.
3. Carriage inwards is the cost of transport of goods into the firm and is therefore added to the purchases figure.
4. Carriage outwards is the cost of transport of goods out of the firm to its customers, it is not part of the firm's expenses in buying the goods and is always entered as an expense.

Definitions of Assets Liabilities ...

Assets

An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Some assets are held and used in operations for a long time. These are known as **non-current assets.**

Other assets are held for only a short time. They are likely to be realized within the normal operating cycle or 12 months after

the end of the reporting period. These are classified as **current assets.**

Liabilities

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Some liabilities are due to be settled within the normal operating cycle or 12 months after the end of the reporting period. These are classified as **current liabilities.**

Other liabilities may take some years to repay – **non-current liabilities.**

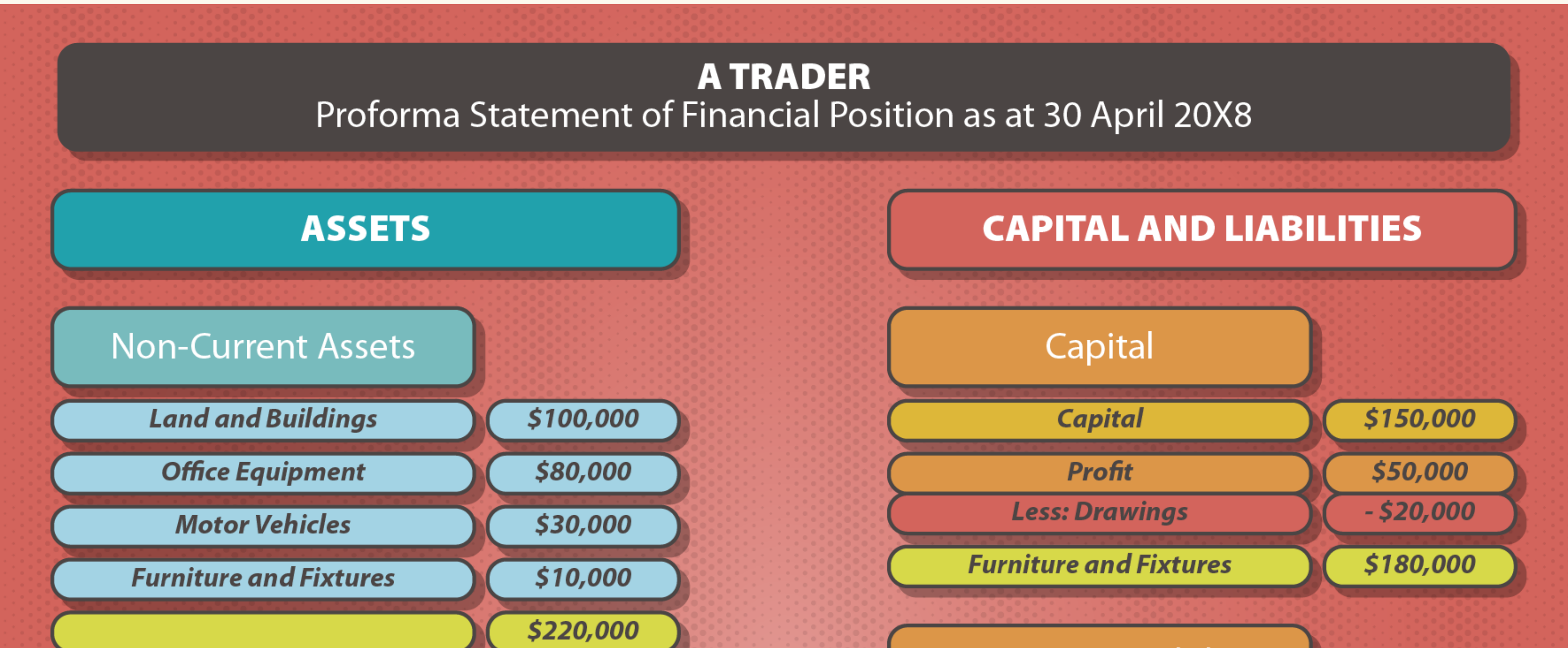
Capital / Equity

Capital is the amount invested in a business by the owner. This is the amount the business owes to the owner. In the case of a sole trader,

CAPITAL = ASSETS – LIABILITIES

CAPITAL = NET ASSETS

In the case of a limited liability company, capital usually takes the form of shares. Share capital is known as equity. The Framework defines equity as “the residual interest in the assets of the entity after deducting all its liabilities.”



Non-Current Assets	
Inventories	$30,000
Trade Receivables	$27,000
Less: Allowance for Receivables	- $2,000
	$25,000
Furniture and Prepayments	$15,000
Cash in Hand and at Bank	$10,000
	$80,000
TOTAL ASSETS	**$300,000**

Non-Current Liabilities	
Bank Loans	$60,000
Current Liabilities	
Bank Overdraft	$20,000
Trade Payables	$30,000
Accruals	$10,000
	$60,000
TOTAL CAPITAL AND LIABILITIES	**$300,000**

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Revenue

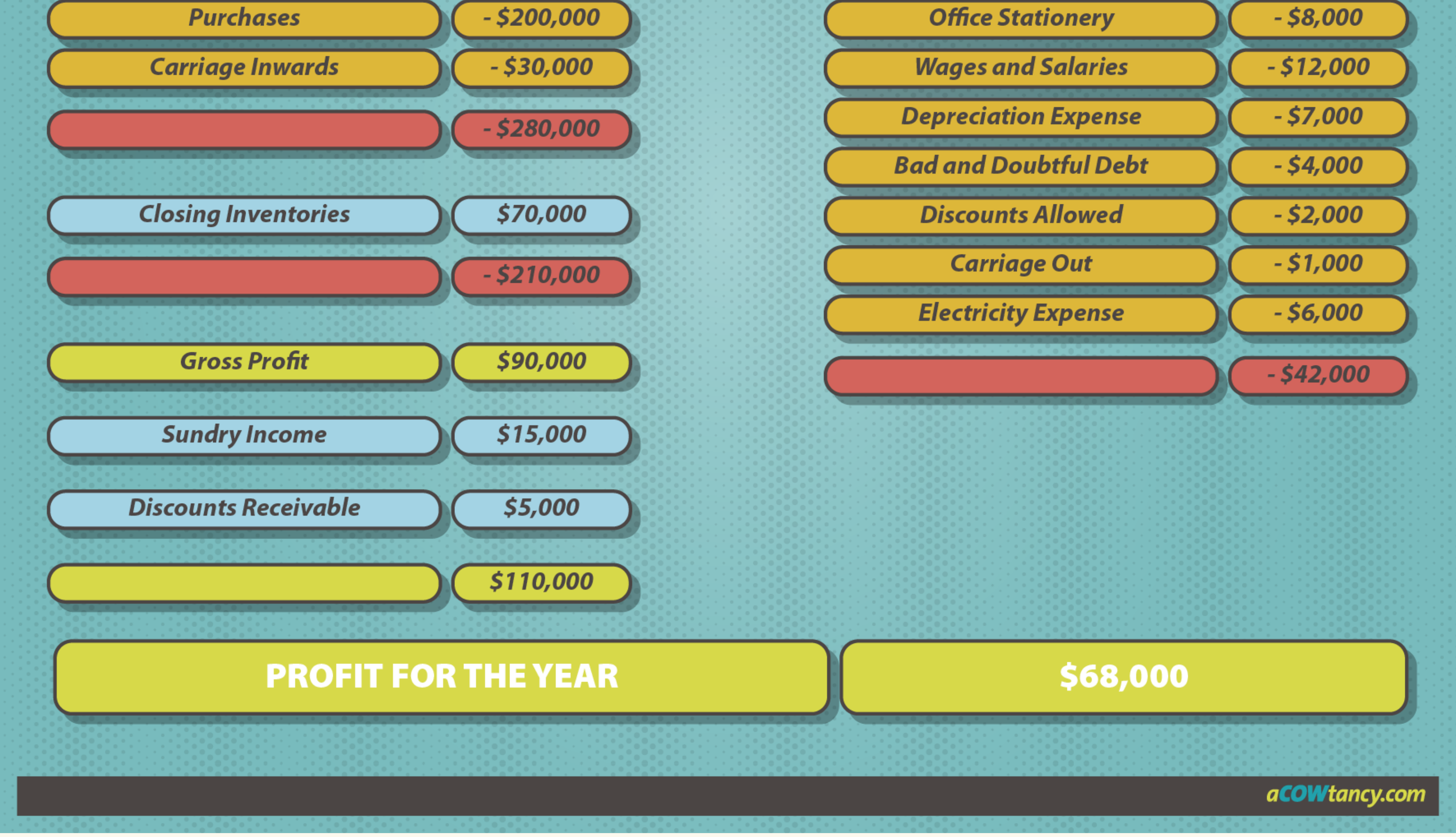
Revenue is the income for a period. It is the gross inflow of economic benefits (cash, receivables, other assets) arising from the ordinary operating activities of an enterprise (such as sales of goods, sales of services, interest, royalties, and dividends).

Expenses

Expenses arise in the course of the ordinary activities of the enterprise. They include, for example, cost of sales, wages and depreciation.

A TRADER
Proforma Statement of Profit or Loss for the Year ending 30 April 20X8

SALES	**$300,000**		
Less: Cost of Sales		Less: Expenses	
Opening Inventories	- $50,000	Telephone Expenses	- $2,000



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The regulatory framework

The role of the regulatory systems

Introduction

Limited liability companies are required by law to prepare and publish financial statements annually. The form and content of these accounts are primarily regulated by national legislation. They must also comply with International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs).

Accounting Standards

International Accounting Standards were issued by the IASC from 1973 to 2000. They provide guidance as to how items should be shown in a set of financial statements both in terms of their monetary value and any other disclosures. They are a single set of high quality, understandable and enforceable global standards.

The IASB replaced the IASC in 2001. Since then, the IASB has amended some IASs and has proposed to amend others, has replaced some IASs with new International Financial Reporting Standards, and has adopted or proposed certain new IFRSs on topics for which there was no previous IAS.

Accounting standards were developed for two main reasons

> To reduce subjectivity
>
> To achieve comparability between different organisations

Financial statements may not be described as complying with IFRSs unless they comply with all of the requirements of each applicable standard and each applicable interpretation.

The IFRS Foundation (IFRSF)

The IFRS Foundation is an independent organisation having two main bodies, the Trustees and the International Accounting Standards Board (IASB), as well as the IFRS Advisory Council (IFRS AC) and the IFRS Interpretations Committee (IFRS IC).
The IFRSF is governed by a board of 22 trustees. These trustees appoint the members of the IASB, IFRS IC and the IFRS AC. They also review annually the strategy of the IFRSF and the IASB and its effectiveness, including consideration, but not determination, of the IASB's agenda. These trustees also raise the funds necessary to support the IFRSF.

The International Accounting Standards Board (IASB)

The International Accounting Standards Board (IASB) is an independent, privately-funded accounting standard-setter based in London, UK. There are 14 Board members, each with one vote.

The IASB is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. In addition,

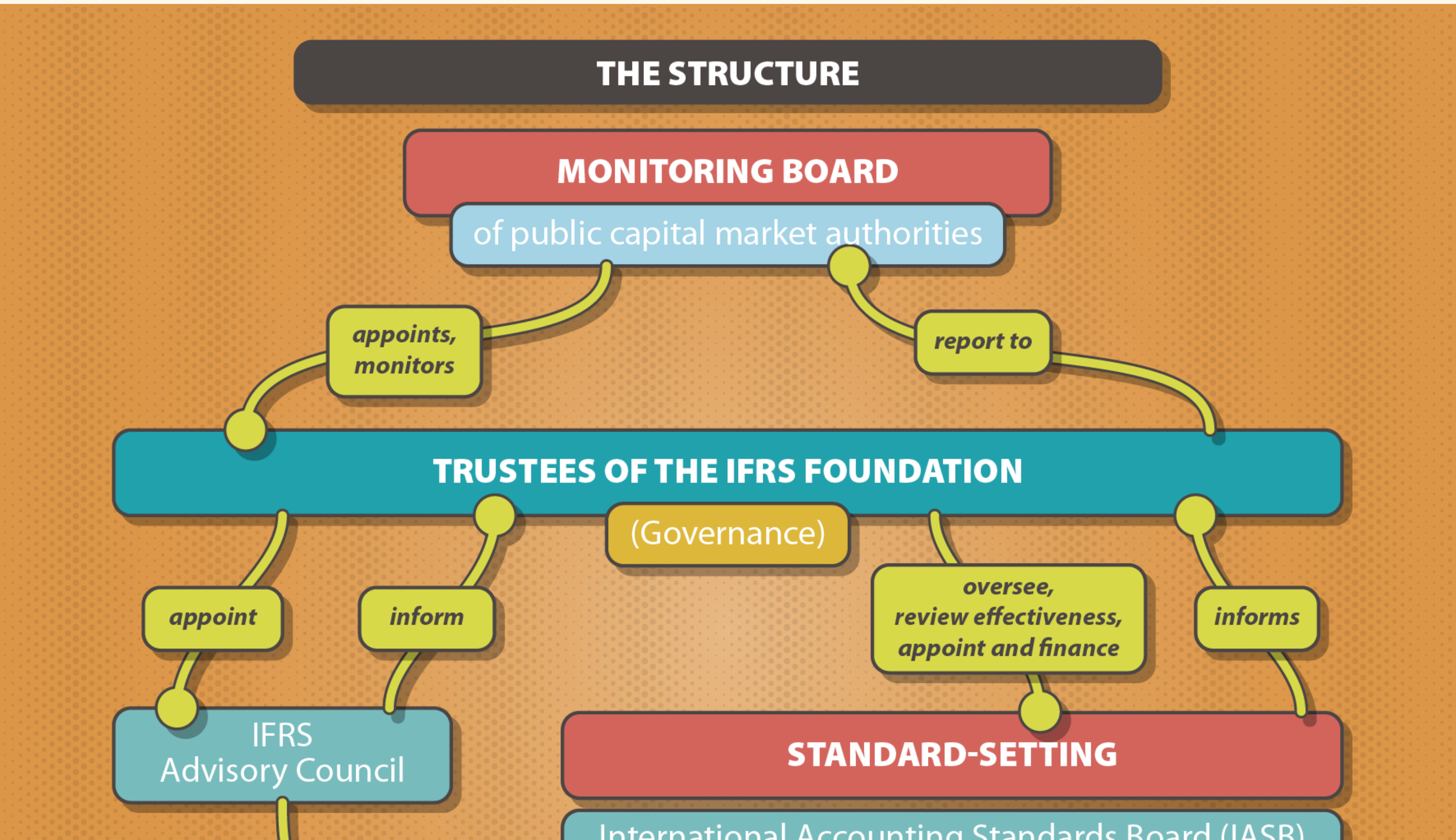
the IASB co-operates with national accounting standard-setters to achieve convergence in accounting standards around the world.

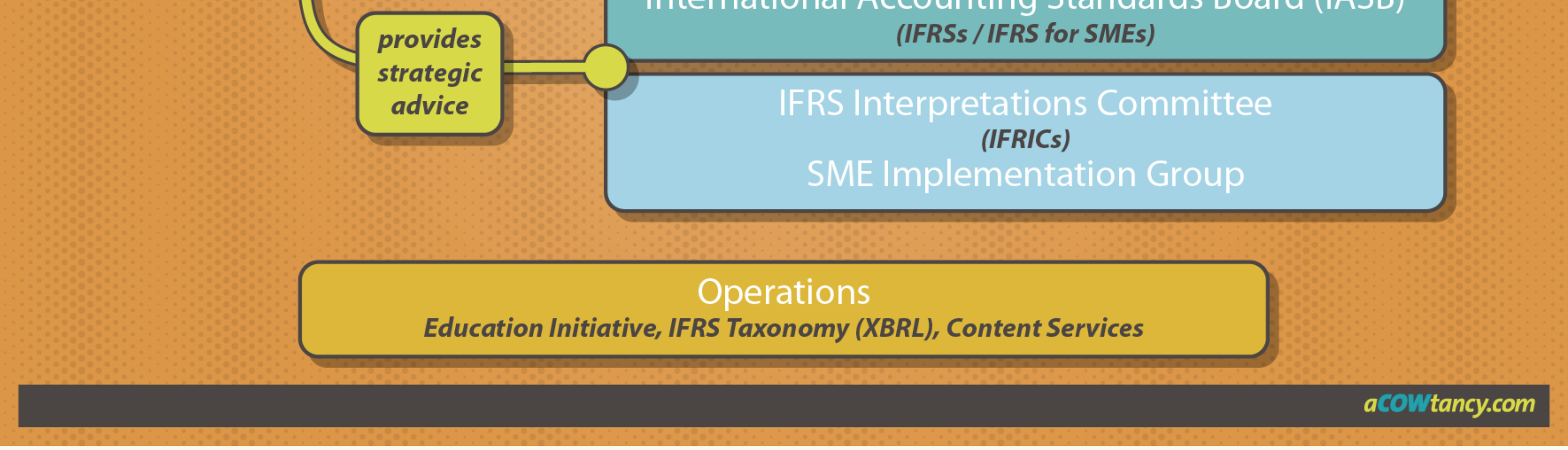
How are standards developed?

International Financial Reporting Standards (IFRSs) are developed through an international consultation process, the "due process" that involves interested individuals and organisations from around the world.

The due process comprises six stages:

1. Setting the agenda;
2. Planning the project, including forming a 'working group' to advise the IASB and its staff on the project;
3. Developing and publishing the discussion paper for public comment;
4. Developing and publishing the exposure draft for public comment. This exposure draft must be approved by vote of at least nine IASB members;
5. Developing and publishing the standard. The standard must be approved by vote of at least nine IASB members and finally
6. The standard is issued





The role of International Financial Reporting Standards

The IFRS Advisory Council (IFRS AC)

The IFRS Advisory Council (IFRS AC) gives advice to the IASB on a range of issues which includes, but is not limited to, the following:

1. input on the IASB's agenda;
2. input on the IASB's project timetable (work programme) including project priorities, and consultation on any changes in agenda and priorities; and
3. advise on projects, with particular emphasis on practical application and implementation issues, including matters relating to existing standards that may warrant consideration by the IFRS Interpretations Committee (IFRS IC)

The IFRS AC also supports the IASB in the promotion and adoption of IFRSs throughout the world. This may include the publishing of articles supportive of IFRSs and addressing public meetings on the same subject.

The IFRS Interpretations Committee (IFRS IC)

The IASB's interpretative body, was reconstituted in December 2001 as the International Financial Reporting Interpretations Committee (IFRIC).

The IFRIC reviews, on a timely basis within the context of current International Financial Reporting Standards (IFRSs) and the IASB Framework, accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance, with a view to reaching consensus on the appropriate accounting treatment.

In developing interpretations, the IFRS IC works closely with similar national committees

In developing interpretations, the IFRS IC works closely with similar national committees.

The IFRS IC addresses issues of reasonably widespread importance, not issues that are of concern to only a small minority of entities.

The interpretations cover both:

- newly identified financial reporting issues not specifically dealt with in IFRSs; or
- issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop in the absence of authoritative guidance, with a view to reaching a consensus on the appropriate treatment.

Duties and responsibilities of those charged with governance

Governance in preparation of financial statements

Corporate governance was defined by the Cadbury Committee as: 'The system by which an organisation is directed and controlled, at its most senior levels, in order to achieve its objectives and meet the necessary standards of accountability and probity.'

Corporate governance is not solely about introducing systems of control, it is fundamentally linked to directing the organisation in order to achieve objectives. This is critical to the success of the organisation and is a central part of the role of the board of directors

Duties and responsibilities of directors in preparation of financial statements

Board of Directors

The most prominent group of actors in corporate governance are the company's directors. They can be either executive or non-executive directors (NEDs).

The UK Companies Act sets out seven statutory duties of directors. Directors should

1. Act within their powers
2. Promote the success of the company
3. Exercise independent judgement

4. Exercise reasonable skill, care and diligence
5. Avoid conflicts of interest
6. Not accept benefits from third parties
7. Declare an interest in a proposed transaction or arrangement.

Directors' considerations

1. The consequences of decisions in the long term
2. The interests of their employees
3. The need to develop good relationships with customers and suppliers
4. The impact of the company on the local community and the environment
5. The desirability of maintaining high standards of business conduct and good reputation
6. The need to act fairly between all members of the company

Directors' Responsibility for the Financial Statements

The directors are responsible for preparing the annual financial statements in accordance with applicable law and regulations. Company law requires the directors to prepare financial statements for each financial year and such financial statements must give a true and fair view. Hence, the directors are required to:

> select suitable accounting policies and then apply them consistently;
>
> make judgments and estimates that are reasonable and prudent; and;
>
> state whether they have been prepared in accordance with IFRSs.

Directors are responsible for the internal controls necessary to enable the preparation of financial statements that are free from material misstatement, whether due to error or fraud. They are also responsible for the prevention and detection of fraud.

Financial statements of companies are usually audited. An audit is an independent examination of the accounts to ensure that they comply with legal requirements and accounting standards. The findings of the audit are reported to the shareholders.

The qualitative characteristics of financial information

Qualitative characteristics

Qualitative characteristics

The IASB's Conceptual Framework for Financial Reporting

The IASB's Conceptual Framework for Financial Reporting describes the basic concepts by which financial statements are prepared. The main purpose of the Framework is to:

1. assist in the development of future IFRS and the review of existing standards by setting out the underlying concepts
2. promote harmonisation of accounting regulation and standards by reducing the number of permitted alternative accounting treatments
3. assist the preparers of financial statements in the application of IFRS, which would include dealing with accounting transactions for which there is not (yet) an accounting standard.

Qualitative Characteristics of Financial Information

The revised Framework distinguishes between two types of qualitative characteristics that are necessary to provide useful financial information: -

> Fundamental qualitative characteristics (relevance and faithful representation) and
>
> enhancing qualitative characteristics (comparability (including consistency), timeliness, verifiability and understandability).

Fundamental Qualitative Characteristics

For information to be useful, it must be both relevant and faithfully represented

1. **Relevance**
    1. **Influences economic decisions of user**

    Relevant financial information is capable of making a difference in the decisions made by users

2. **Has predictive value and/or confirmatory value or both**

   Relevant information assists in the predictive ability of financial statements. That is not to say the financial statements should be predictive in the sense of forecasts, but that (past) information should be presented in a manner that assists users to assess an entity's ability to take advantage of opportunities and react to adverse situations.

3. **Materiality**

   Materiality is a threshold or cut-off point for information whose omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. This depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Hence, materiality is not a matter to be considered by standard-setters but by preparers and their auditors.

2. **Faithful Representation**

General purpose financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only be relevant, it must also represent faithfully the phenomena it purports to represent. Financial statements will generally show a fair presentation when

· They conform with accounting standards
· They conform with the any relevant legal requirements
· They have applied the qualitative characteristics from the Framework.

Financial information that faithfully represents economic phenomena has three characteristics: -

it is complete
it is neutral
it is free from error

Enhancing Qualitative Characteristics

Comparability, verifiability, timeliness and understandability are directed to enhance both relevant and faithfully represented financial information. Those characteristics should be maximised both individually and in combination.

1. **Comparability**

   1. **Users can identify similarities and differences**

      Comparability is fundamental to assessing the performance of an entity by using its financial statements. Assessing the performance of an entity over time (trend analysis) requires that the financial statements used have been prepared on a comparable (consistent) basis.

   2. **Consistent application of methods**

Comparability is enhanced by the use and disclosure of consistent accounting policies. Users can confirm that comparative information for calculating trends is comparable. The disclosure of accounting policies at least informs users if different entities use different policies.

Comparability should be distinguished from consistency (the consistent use of accounting methods). It is recognised that there are situations where it is necessary to adopt new accounting policies (usually through new Standards) if they enhance relevance and reliability. Consistency and comparability require the existence and disclosure of accounting policies.

2. Verifiability

Financial information is verifiable when it enables knowledgeable and independent observers to reach a consensus on whether a particular depiction of an event or transaction is a faithful representation.

3. Timeliness

Timeliness means that information is available to decision-makers in time to be capable of influencing their decisions.

4. Understandability

Understandability is enhanced when the information is:

> classified
>
> characterised
>
> presented clearly and concisely

However, relevant information should not be excluded solely because it may be too complex and cannot be made easy to understand. To exclude such information would make financial reports incomplete and potentially misleading. Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information with diligence.

The Cost Constraint on Useful Financial Reporting

Cost is a pervasive constraint to financial reporting. Reporting such information imposes costs and those costs should be justified by the benefits of reporting that information.

The IASB assesses costs and benefits in relation to financial reporting generally, and not solely in relation to individual reporting entities. The IASB will consider whether different sizes of entities and other factors justify different reporting requirements in certain situations.

Accounting concepts

Underlying Assumptions

The Framework sets out two concepts which can be presumed when reading financial statements:

Accrual Basis

The effects of transactions and other events are recognised when they occur, rather than when cash or its equivalent is received or paid, and they are reported in the financial statements of the periods to which they relate.

Going Concern

The financial statements presume that an enterprise will continue in operation in the foreseeable future or, if that presumption is not valid, disclosure and a different basis of reporting are required.

Other Accounting Concepts

The business entity concept (separate entity)

In accounting, a business should always be treated separately from its owner(s).

Fair presentation

The financial statements must "present fairly" the financial position, financial performance and cash flows of an entity.

Fair presentation requires the faithful representation of the effects of transactions, other events, and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework.

IAS 1, “Presentation of Financial Statements” states that: -

1. compliance with IFRSs should be disclosed
2. All relevant IFRS must be followed if compliance with IFRSs is disclosed

In some rare circumstances, management may decide that compliance with a requirement of an IFRS would be misleading. Departure from the IFRS is therefore required to achieve a fair presentation.

misleading. Departure from the IFRS is therefore required to achieve a fair presentation.

IAS 1 states that for a fair presentation, the following is required: -

1. selection and application of accounting policies
2. presentation of information in a manner which provides relevant, reliable, comparable and understandable information
3. additional disclosures when required

Substance over form

Transactions need to be accounted for and presented in accordance with their substance and economic reality even if their legal form is different.

Historical Cost

Historical cost has been defined as the amount paid or fair value of the consideration given.

Advantages of Historical Cost Accounting

The cost is known and can be proved (e.g. against an invoice). It is therefore objective

It enhances comparability

It leads to stable pricing – using current market values would lead to volatility in asset values

Disadvantages of Historical Cost Accounting

Non-current asset values are unrealistic

Since non-current asset values are low, depreciation is low and does not fully reflect the value of the asset consumed during the accounting year

Lower costs, e.g. depreciation expense, would lead to higher profits. There is a possibility that this may lead to higher taxation, wage demands and dividend expectation (based on overstated earnings per share). The combination of these effects is that a company may overspend or over distribute its profits and not maintain its capital base.

- Comparisons over time are unrealistic

- Understatement of asset values tends to overstate gearing, and leads to a low asset per share value and can make the company vulnerable to a take over

- Where assets, particularly land and buildings, are being used as security to raise finance, it is current value that lenders are interested in, not historical values

These disadvantages usually arise in times of rising prices. In fact, **in times of rising prices, historical cost accounting tends to understate asset values and overstate profits.**

The use of double-entry and accounting systems

Double-entry book-keeping principles

Main data sources

The function of the main data sources in an accounting system

A business will enter many transactions during the year. All of these need to be recorded and summarized to produce the entity's financial statements.

These business transactions are recorded on source documents. These documents are the source of all the information recorded by a business. Examples include sales and purchase orders, invoices and credit notes.

Contents and purpose

The contents and purpose of different types of business documentation

Documents used to record business transactions include

- Quotation: - a business makes a written offer to a customer to produce or deliver goods or services for a certain amount of money

Sales Order: - a customer writes out or signs an order for goods or services he requires

Purchase Order: - a business orders from another business goods or services

Goods received note: - a list of goods that a business has received from a supplier

Goods despatched note: - a list of goods that a business has sent out to a customer

Invoice: - An invoice relates to a sales order or a purchase order. When a business sells goods or services on credit to a customer, it sends out an invoice. When a business buys goods or services on credit, it receives an invoice from the supplier.

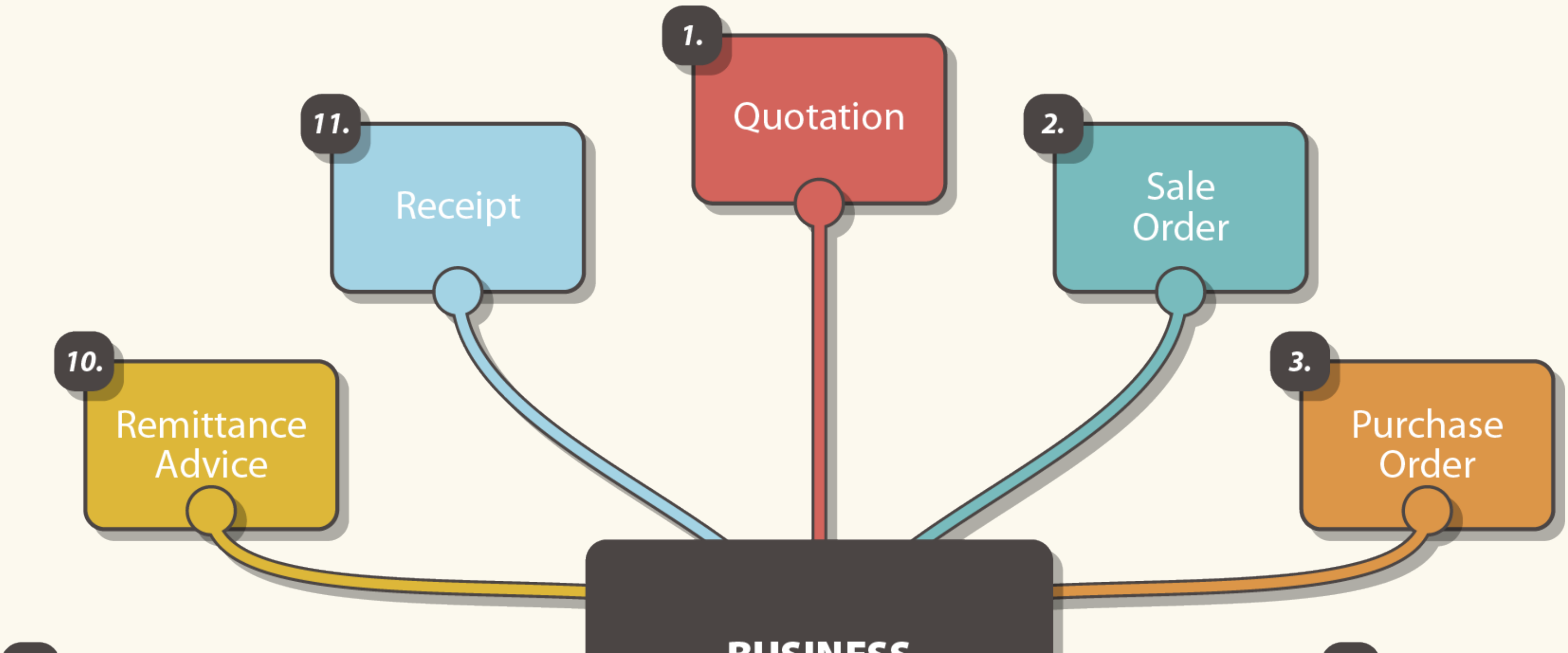
Statement: - A document sent by a supplier to a customer listing all invoices, credit notes and payments done by the customer

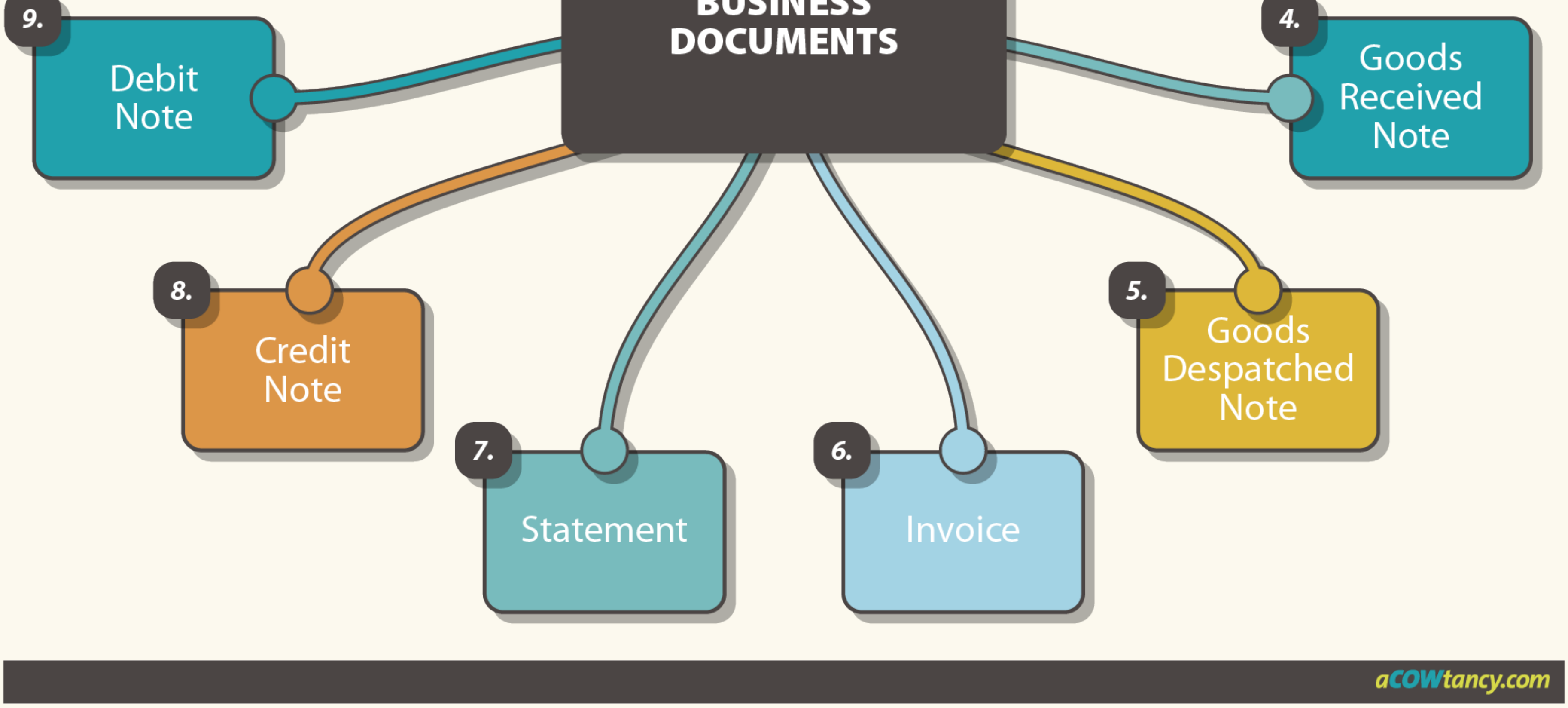
Credit note: - a document sent by a supplier to a customer in respect of goods returned or overpayments made by the customer

Debit note: - a document sent by a customer to a supplier in respect of goods returned or an overpayment made. It is a formal request for the supplier to issue a credit note

Remittance advice: - a document sent with a payment, detailing which invoice are being paid and which credit notes offset

Receipt: - a written confirmation that money has been paid.





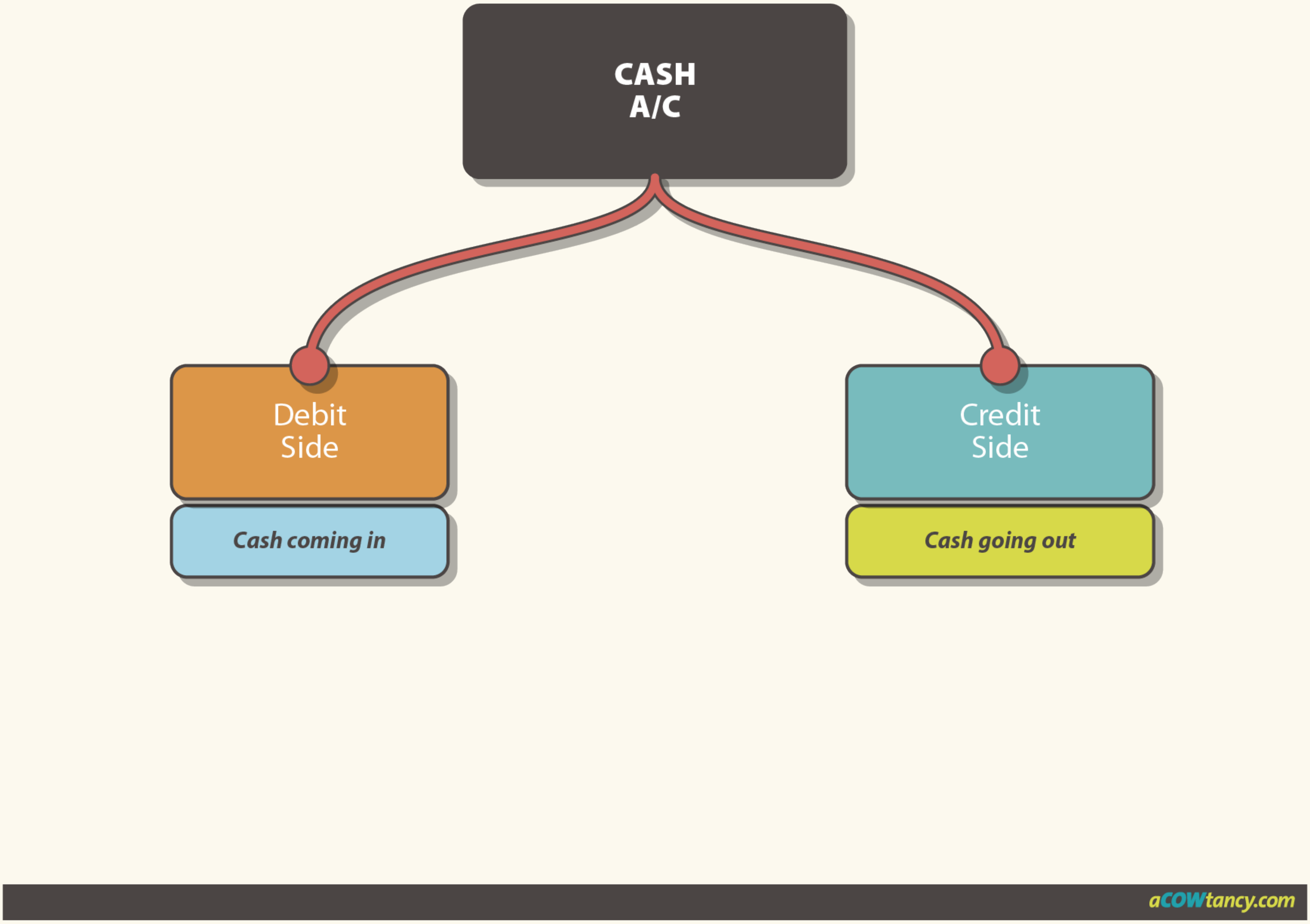
Double entry accounting

Books of Prime Entry

As we have seen in the previous chapter, repetitive transactions may initially be captured in day books (also known as books of prime entry) e.g., all the sales invoices may be listed in the sales day book. These day books are not part of the double-entry system but enable the number of double-entries to be reduced by ascertaining an aggregate

Nominal Ledger

The total of the day book, or the single transaction, is recorded in the double-entry system by being posted to the nominal accounts in the general/nominal ledger. Each nominal account (or T account) has two sides, the left hand side of which is called the debit side (DR) and the right hand side of which is called the credit side (CR).



Nominal accounts are normally opened for each asset and liability (or class thereof), and one for each type of expense and income. In addition a sole trader will also have an account for capital. Capital represents the proprietary interest in the net assets of the business. It is created when the owner introduces resources into the business entity and increases when the business generates a profit.

As already mentioned, only transactions capable of being measured objectively in monetary terms can be recorded (this is known as the money measurement concept).

Double-entry rules

Rule 1: - The duality rule

Every transaction has two effects, one of which will be recorded as a debit in one account and the other which will be recorded as a credit in another account. If this rule is broken, the trial balance will not agree and a suspense account is opened. This will be discussed later in “Correction of Errors”.

TOTAL DEBITS = TOTAL CREDITS

Rule 2: - The when to DR and CR rule

The rules as to when to debit a T account and when to credit a T account can be summarized in the following table.

The Debit/Credit Table:

	increase	**decrease**
asset expense purchases drawings	debit	credit
liability income sales capital	credit	debit

Rule 3: - Debit is on the left and credit is on the right

Accounting equation

The Accounting Equation

E.g. Statement of Financial Position – M. Stark

E.g. Statement of Financial Position – M. Stark

assets	**$**	**liabilities**	**$**
motor vehicles	10000	trade payables	3000
inventory	4000	propietor's interest	
receivables	2000	capital	13000
cash	3000	profit	4000
		drawings	(1000)
	--------		--------
	19000		19000

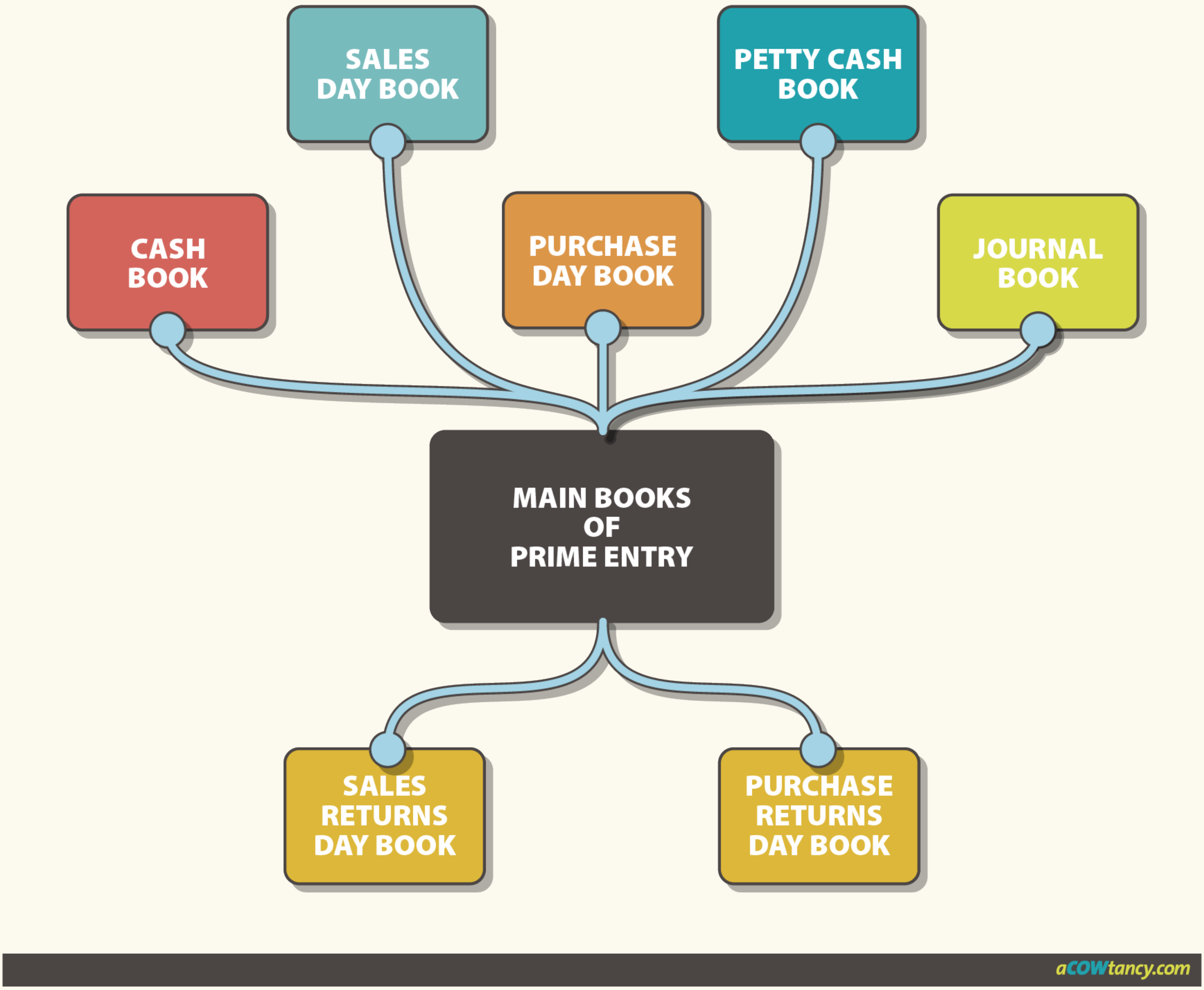
Assets = Liabilities

Assets = (Capital + Profit – Drawings) + Payables
Assets – Payables = Capital +Profit – Drawings
Net Assets = Proprietor's Interest

How the accounting system contributes
Business transactions

Ledger accounts, books of prime entry and journals

Ledger accounts and books of prime entry



Cash Book

The cash book records receipts and payments into and out of the business bank account. These would include receipts and payments made by bank transfer, standing order, direct debit and bank interest and charges, directly by the bank.

(RECEIPTS)

Date	Narrative	Total	Accounts Receivable	Cash Sales	Other
20X8					
1 Oct	Balance B/D	$1,000			
4 Oct	Cash Sale	$500		$500	
12 Oct	Accounts Receivable - Star & Moon Co	$750	$750		
15 Oct	Sale of non-current asset	$350			$350
TOTAL		**$2,600**	**$750**	**$500**	**$350**

CASH BOOK (PAYMENTS)

Date	Narrative	Total	Accounts Payable	Cash Sales	Other
20X8					
5 Oct	Accounts Payable - Jupiter & Co	$250	$250		
7 Oct	Telephone	$500			$500

9 Oct	Petty Cash	$155		$155	
12 Oct	Purchase of Machinery	$1,250			$1,250
15 Oct	Balance C/D	$445			
TOTAL		$2,600	$250	$155	$1,750

Sales Day Book

The sales day book lists all sales made on credit. It is used to keep a list of all invoices sent out to customers each day.

SALES DAY BOOK

Date	Invoice	Customer	Total Amount Invoiced
20X8			
4 Oct	145	Sunshine Co	$452.60
	146	Clouds Co	$254.20
	147	Star & Moon Co	$845.90

TOTAL	$1,552.70

Sales Returns Day Book

When customers return goods for some reason, a credit note is raised. All credit notes are recorded in the sales returns day book.

Purchase Day Book

The purchase day book lists all purchases made on credit, i.e. a list of all invoices it receives.

PURCHASE DAY BOOK

Date	Supplier	Total Amount Invoiced
20X8		
1 Oct	*Jupiter & Co*	*$556.10*
	Mars & Co	*$189.60*
	Venus & Co	*$245.50*

Purchase Returns Day Book

The purchase returns day book records credit notes received in respect of goods which the business sends back to its suppliers.

Petty Cash Book

Most businesses keep a small amount of cash on the premises to make occasional small payments in cash, e.g. staff refreshments, postage stamps, to pay the office cleaner, taxi fares, etc. This is often called the cash float or petty cash account. Therefore, the petty cash book is a cash book for small payments.

Very often these businesses use the imprest system. Under the imprest system, the petty cash is kept at an agreed sum, so that each topping up is equal to the amount paid out in the period.

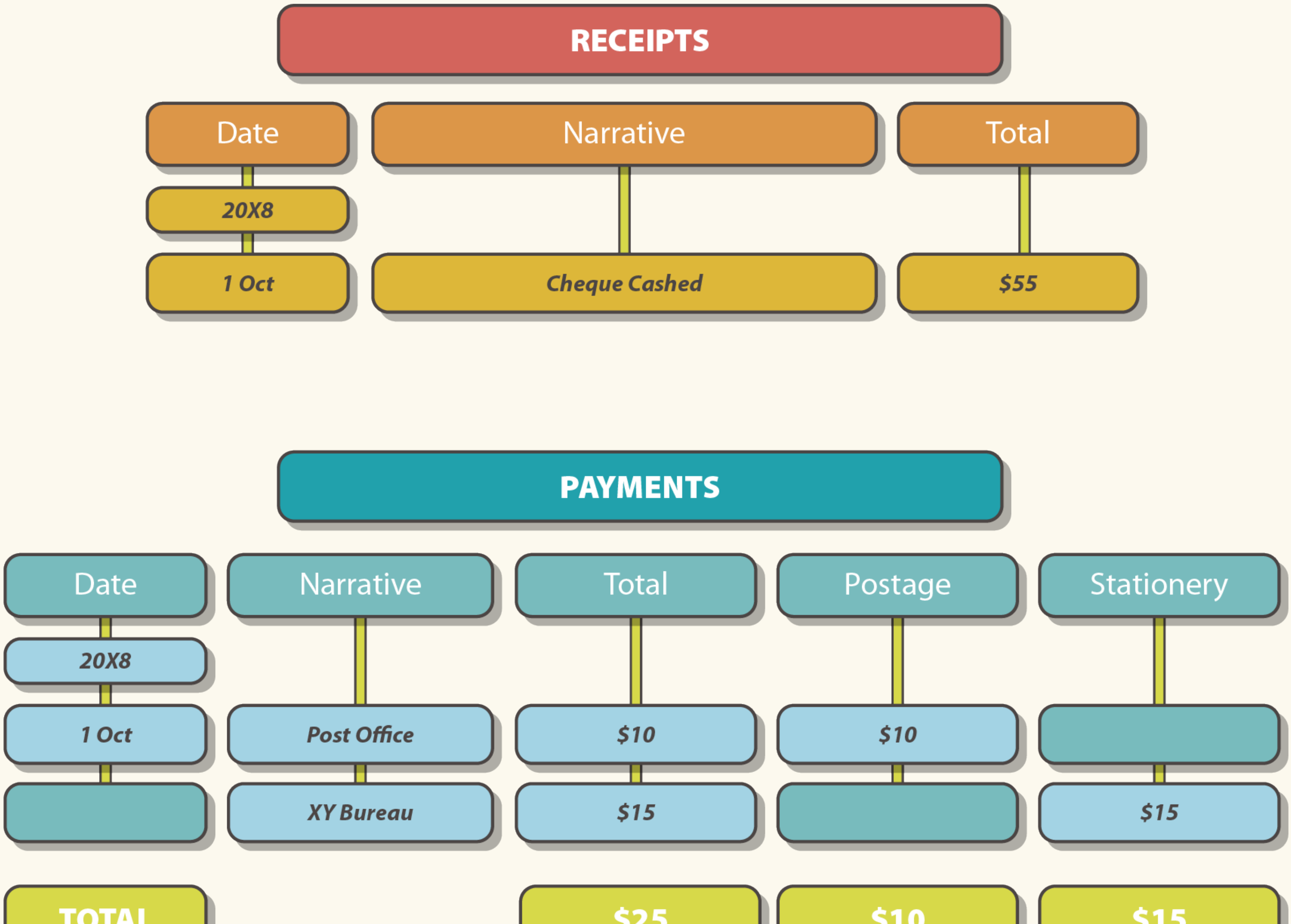
Example

The amount of money in petty cash is kept at an agreed sum of $250. Expense items are recorded on vouchers as they occur and the total voucher payments for the period were $55. Therefore:

	$
cash still held in petty cash (250 - 55)	195

plus voucher payments (25+5+10+15)	55
	----
must equal the agreed sum or float	250
	===

The cash payment required from the bank account into petty cash is equal to $55, i.e. total of the voucher payments since the previous top-up.



Keeping cash (even in small amounts) on the premises is a security risk. Therefore a petty cash system is usually subject to strict controls.

1. Payment is only made in respect of authorised claims.
2. All claims are supported by evidence.

Uses of journals

Journal Book

The journal keeps a record of unusual movement between accounts. It is used to record any double entries made which do not arise from the other books of prime entry. For example, journal entries are made when errors are discovered and need to be corrected and for period end adjustments (depreciation, bad and doubtful debts, accruals and prepayments).

The format of a journal entry is

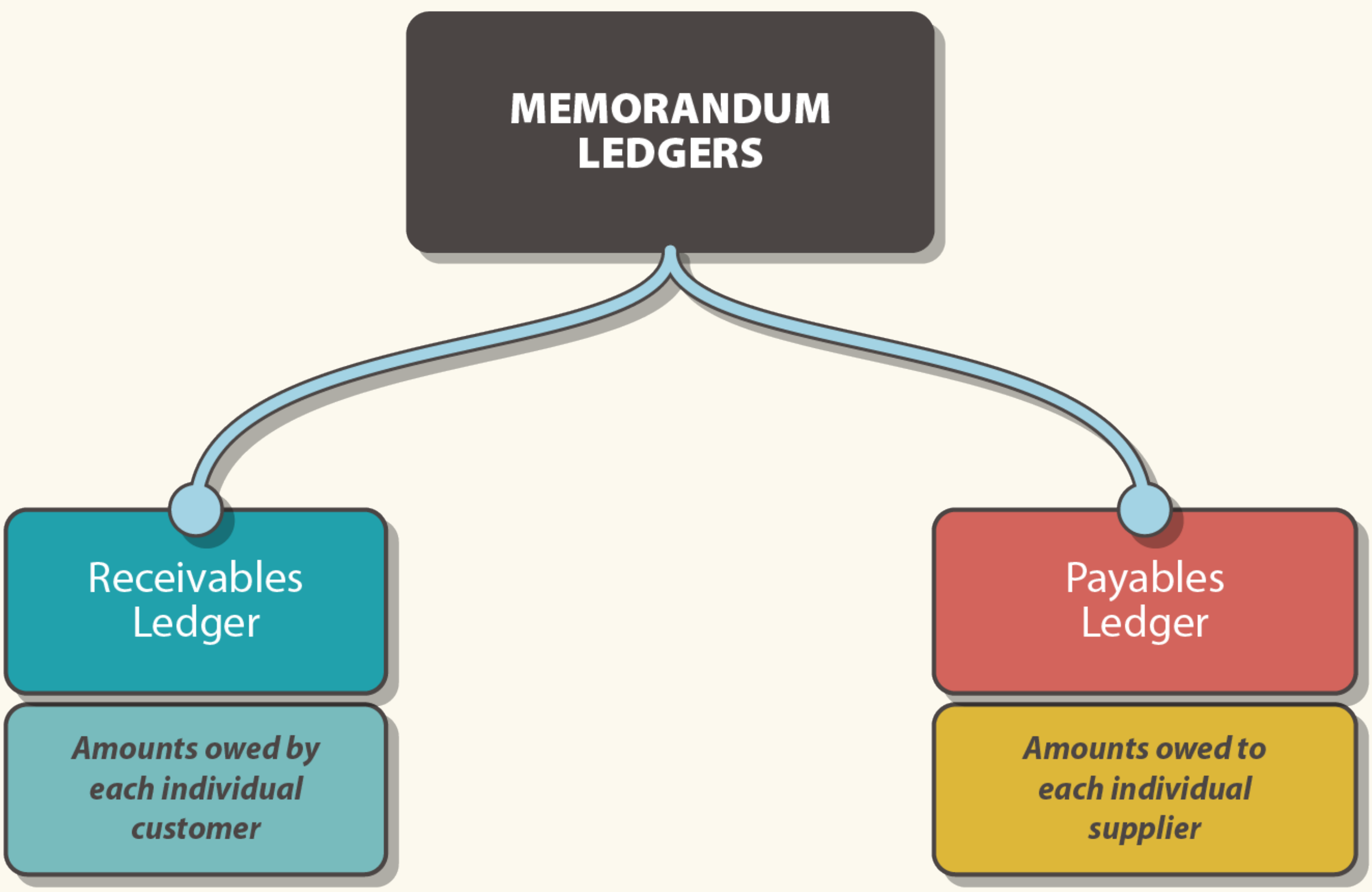
	debit	credit
	$	$
account to be debited		
account to be credited		
narrative to explain the transaction		

Memorandum Ledgers

The main purpose of memorandum ledgers is to know how much is owed by each particular customer or to a specific supplier at a point in time.

There are two main types of memorandum ledgers

> Receivables Ledger
>
> Payables Ledger



Receivables Ledger

This ledger shows how much is owed to the business by each individual customer

sunshine co				
date	narrative	sales	cash	total
		$	$	$
oct 4	invoice 145	452.60		452.60

clouds co				
date	narrative	sales	cash	total
		$	$	$
oct 4	invoice 146	254.20		254.20

star & moon co				
date	narrative	sales	cash	total
		$	$	$

oct 4 oct 12	invoice 147	845.90	 750.00	845.90 95.90

Payables Ledger

This ledger shows how much is owed by the business to each individual supplier.

jupiter co				
date	narrative	cash	purchase	total
		$	$	$
oct 1 oct 5	invoice j851 cash book	 250.00	556.10	556.10 306.10

mars co				
date	narrative	cash	purchase	total
		$	$	$
oct 1	invoice m048		189.60	189.60

venus & co				
date	narrative	cash	purchase	total
		$	$	$
oct 1	invoice 0124		245.50	245.50

Correct journals
Balance and close a ledger

The totals from the books of prime entry are posted to the nominal accounts in the nominal ledger through double-entry. A business will want to know the balance on each account. This is done by 'balancing off' each account.

Steps to balance off a ledger account

1. Add the debit and credit sides separately.
2. Fill in the higher of the two totals on both sides.
3. 'Balance' the account (make the two sides equal) – balance c/d
4. Complete the 'double entry' – balance b/d on the opposite side.

Recording transactions and events

Sales and purchases

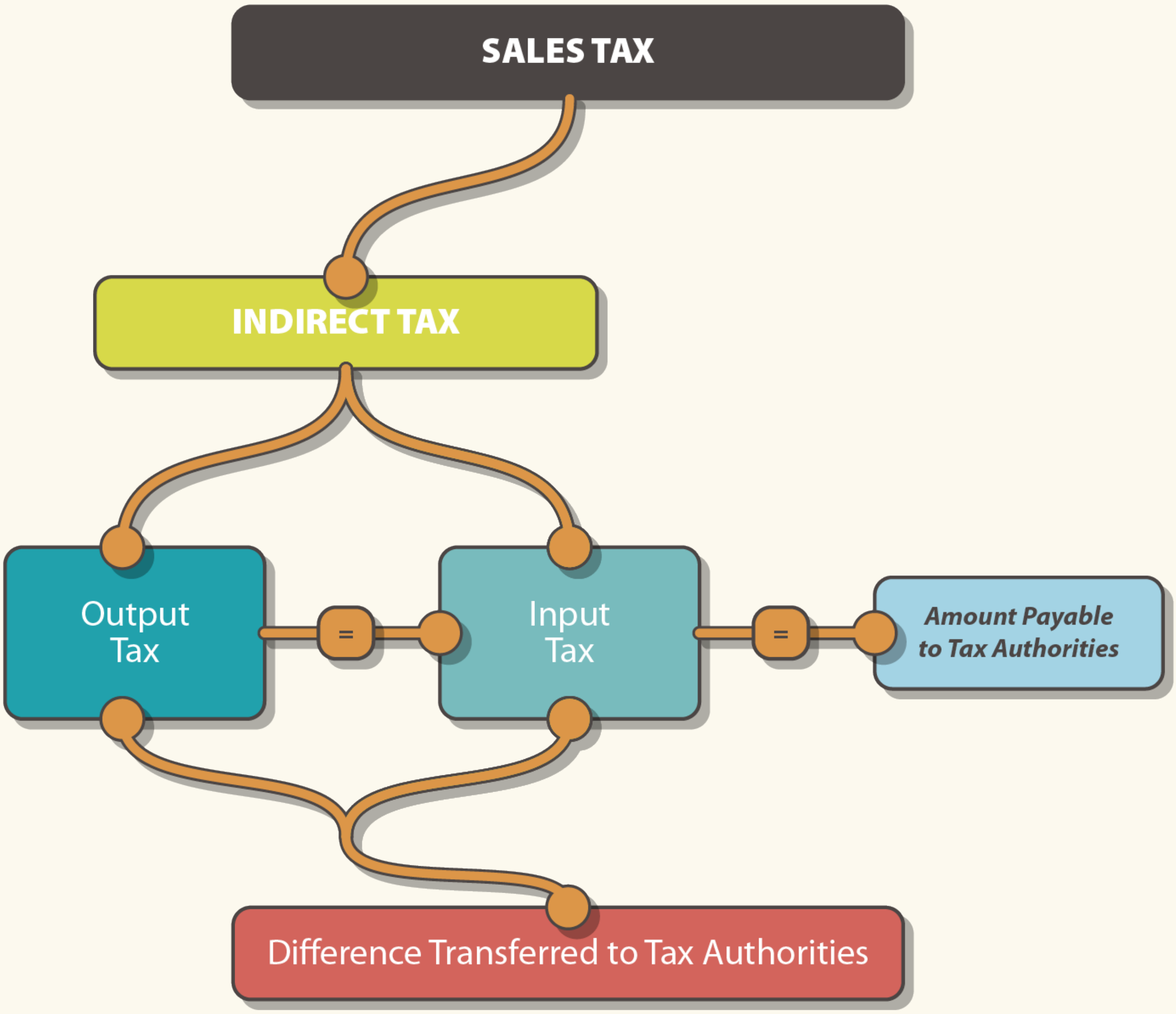
General principles of a sales tax

Sales tax is an indirect tax on the supply of goods and services which is eventually borne by the final customer, but it is collected at each stage of the production and distribution chain

Input and Output Tax

Sales tax charged on goods and services sold by a business is referred to as output tax. Sales tax paid on goods and services 'bought in' by a business is referred to as input tax.

If output sales tax exceeds input sales tax, the business pays the difference in tax to the authorities. If output sales tax is less than input sales tax in a period, the tax authorities will refund the difference to the business.



Calculate sales tax

Accounting Treatment

Registered businesses charge output sales tax on sales and suffer input sales tax on purchases. Sales tax does not affect the statement of profit or loss, but is simply being collected on behalf of the tax authorities to whom a quarterly payment is made.

Therefore, if a business sells goods for $1,000 + 17.5% sales tax, the accounting entries to record the sale would be: -

Dr Cash/trade receivables(Gross) $1,175
Cr Sales (Net) $1,000
Cr Sales tax control account $175

If input sales tax is recoverable, the cost of purchases should exclude the sales tax and be recorded net of tax. Therefore, if a business purchases goods on credit for $500 + 17.5% sales tax, the accounting entries would be: -

Dr Purchases $500.00
Dr Sales tax control account $87.50
Cr Cash/trade payables $587.50

Irrecoverable Sales Tax

There are some circumstances in which traders are not allowed to reclaim sales tax paid on their inputs. For e.g. sales tax charged on motor cars, other than for resale, and on certain business entertaining expenses is irrecoverable.

In these cases, sales tax must be regarded as part of the cost of the items purchased and included in the statement of profit or loss charge or in the statement of financial position as appropriate.

Therefore, the double entry for buying a motor vehicle, where sales tax is irrecoverable, is: -

Dr Motor Vehicles A/c (cost + sales tax)
Cr Cash A/c (cost + sales tax)

Cash

Inventory.

Adjustments for inventory

Inventories

Inventories are assets:

Inventories are assets:

> held for sale in the ordinary course of business;
>
> in the process of production for such sale; or
>
> in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Inventory can be a significant figure for some businesses, e.g. manufacturing companies.

It affects the financial statement in two ways:

1. Statement of financial position: it is included as a current asset

2. Statement of profit or loss: opening and closing inventory have a direct impact on cost of sales and therefore profits. (The cost of goods sold is calculated as: Opening inventory + Purchases – Closing inventory).

All businesses must therefore ensure that their financial statements account for inventory accurately in terms of:

1. the accounting adjustment
2. its valuation

Opening and closing inventory

Inventory is generally accounted for as a year end adjustment via a journal entry.

Opening Inventories

These are the goods held by the business at the beginning of the year. However, such goods will normally have been sold during the year. They are no longer an asset of the entity but will form part of the costs that should be matched against sales revenue when determining profit.

Therefore, opening inventories brought forward in the inventory account are transferred to the trading account.

The accounting entry is:

Dr Cost of sales (I/S)
Cr Inventories (SOFP)

Closing Inventories

Goods might be unsold at the end of an accounting period and so still be held in inventory.

The value of closing inventories is accounted for in the nominal ledger by debiting an inventory account and crediting the trading account at the end of an accounting period. Inventory will therefore have a debit balance at the end of a period, and this balance will be shown in the statement of financial position as a current asset.

The accounting entry is:

Dr Inventories (SOFP)
Cr Cost of sales (I/S)

Alternative methods of valuing

The alternative methods of valuing inventory

The inventories figure is made up of two elements

1. Quantity

   The quantity of inventories held at the year end is established by means of a physical count of inventory in an annual counting exercise, or by a 'continuous' inventory count.

2. Valuation

   The basic rule as per IAS 2 "Inventories" states that:

   Inventories should be measured at the lower of cost and net realisable value

   The value of inventories is calculated at the lower of cost and net realisable value for each separate item or group of items.

   Here, the prudence concept is being applied in presenting financial information.

Other methods

There are other methods which, in theory, might be used for the valuation of inventory

> Inventories might be valued at their expected selling price.
>
> Inventories might be valued at their expected selling price, less any costs still to be incurred in getting them ready for sale and then selling them. This amount is referred to as the net realisable value (NRV) of the inventories.
>
> Inventories might be valued at their historical cost (ie the cost at which they were originally bought).
>
> Inventories might be valued at the amount it would cost to replace them. This amount is referred to as the current replacement cost of inventories

IASB requirements

IAS 2 lays out the required accounting treatment for inventories under the historical cost system. The major area of contention is the cost value of inventory to be recorded. This is recognised as an asset of the enterprise until the related revenues are recognised (i.e. the item is sold) at which point the inventory is recognised as an expense (i.e. cost of sales). Part or all of the cost of inventories may also be expensed if a write-down to net realisable value is necessary.

Costs included in valuing inventories

Cost

The cost of inventories will consist of all the following costs

> Purchase
>
> Costs of conversion
>
> Other costs incurred in bringing the inventories to their present location and condition, e.g. carriage inwards

Costs of purchase

IAS 2 lists the following as comprising the costs of purchase of inventories

Purchase price; plus

Import duties and other taxes; plus

Transport, handling and any other cost directly attributable to the acquisition of finished goods, services and materials; less

Trade discounts, rebates and other similar amounts

Costs of conversion

Costs of conversion of inventories consist of two main parts

1. Costs directly related to the units of production, e.g. direct materials, direct labour
2. Fixed and variable production overheads that are incurred in converting materials into finished goods, allocated on a systematic basis.

Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, e.g. the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, e.g. indirect materials and labour. (IAS 2)

Net Realisable Value

The net realisable value of an item is essentially its net selling proceeds after all costs have been deducted.

It is calculated as:

	$
estimated selling price	x

estimated selling price	x
less: estimated costs of completion	(x)
less: estimated selling and distribution costs	(x)
	----
	x
	===

As a general rule, assets should not be carried at amounts greater than those expected to be realised from their sale or use. In the case of inventories this amount could fall below cost when items are damaged or become obsolete, or where the costs to completion have increased in order to make the sale.

Continuous and period end inventory records

The quantity of inventories held at the year end is established by means of a physical count of inventory in an annual counting exercise, or by a 'continuous' inventory count.

In simple cases, when a business holds easily counted and relatively small amounts of inventory, quantities of inventories on hand at the reporting date can be determined by physically counting them in an inventory count.

In more complicated cases, where a business holds considerable quantities of varied inventory, an alternative approach to establishing quantities is to maintain continuous inventory records. This means that a card is kept for every item of inventory, showing receipts and issues from the stores, and a running total. A few inventory items are counted each day to make sure their record cards are correct – this is called a 'continuous' count because it is spread out over the year rather than completed in one count at a designated time.

FIFO and AVCO

FIFO (first in, first out)

FIFO assumes that materials are issued out of inventory in the order in which they were delivered into inventory, i.e. issues are

priced at the cost of the earliest delivery remaining in inventory

AVCO (average cost)

AVCO calculates a weighted average price for all units in inventory. Issues are priced at this average cost, and the balance of inventory remaining would have the same unit valuation.

A new weighted average price is calculated whenever a new delivery of materials into store is received.

LIFO is no longer permitted under IAS 2.

The impact of accounting concepts

The fundamental accounting assumption of accrual requires costs to be matched with associated revenues. In order to achieve this, costs incurred for goods which remain unsold at the year end must be carried forward in the statement of financial position and matched against future revenues.

In valuing inventory, we also follow the prudence concept which states that a profit cannot be anticipated before it is realised.

A. If inventory is expected to be sold at a profit:

(i) value at cost
(ii) do not anticipate profit.

B. If inventory is expected to be sold at a loss:

(i) value at net realisable value
(ii) do provide for the future loss

Inventory valuation methods

Each method of valuation produces different costs both of closing inventories and also of material issues. Since raw material costs affect the cost of production, and the cost of production works through eventually into the cost of sales, it follows that different methods of inventory valuation will provide different profit figures.

In times of rising prices, using FIFO method will mean the financial statements show higher inventory values and higher profit.

Disclosure notes

Disclosure note for inventory

The financial statements should disclose the following: -

> accounting policy for inventories
>
> carrying amount, generally classified as merchandise, supplies, materials, work in progress, and finished goods. The classifications depend on what is appropriate for the entity
>
> carrying amount of any inventories carried at fair value less costs to sell
>
> amount of any write-down of inventories recognised as an expense in the period

Example of disclosure note

> Note 1: Accounting Policies
>
> Inventories
>
> Inventories are valued at the lower of cost and net realizable value. Cost is determined using first in, first out method. Net realizable value is the estimated selling price in the ordinary course of business, less the costs estimated to make the sale.
>
> Note 10: Inventories

	2011	**2010**
raw materials	15,000	17000
work in progress	10000	13000
finished goods	25000	15000

[illegible]	[illegible]	[illegible]
	--------	--------
	50000	45000
	======	======

Tangible non-current assets.

Definition.

Non-current assets - all assets other than current assets shall be classified as non-current assets. They include both tangible and intangible assets.

The accounting treatment of tangible non-current assets is covered by IAS 16: Property, Plant and Equipment

Current and non-current assets

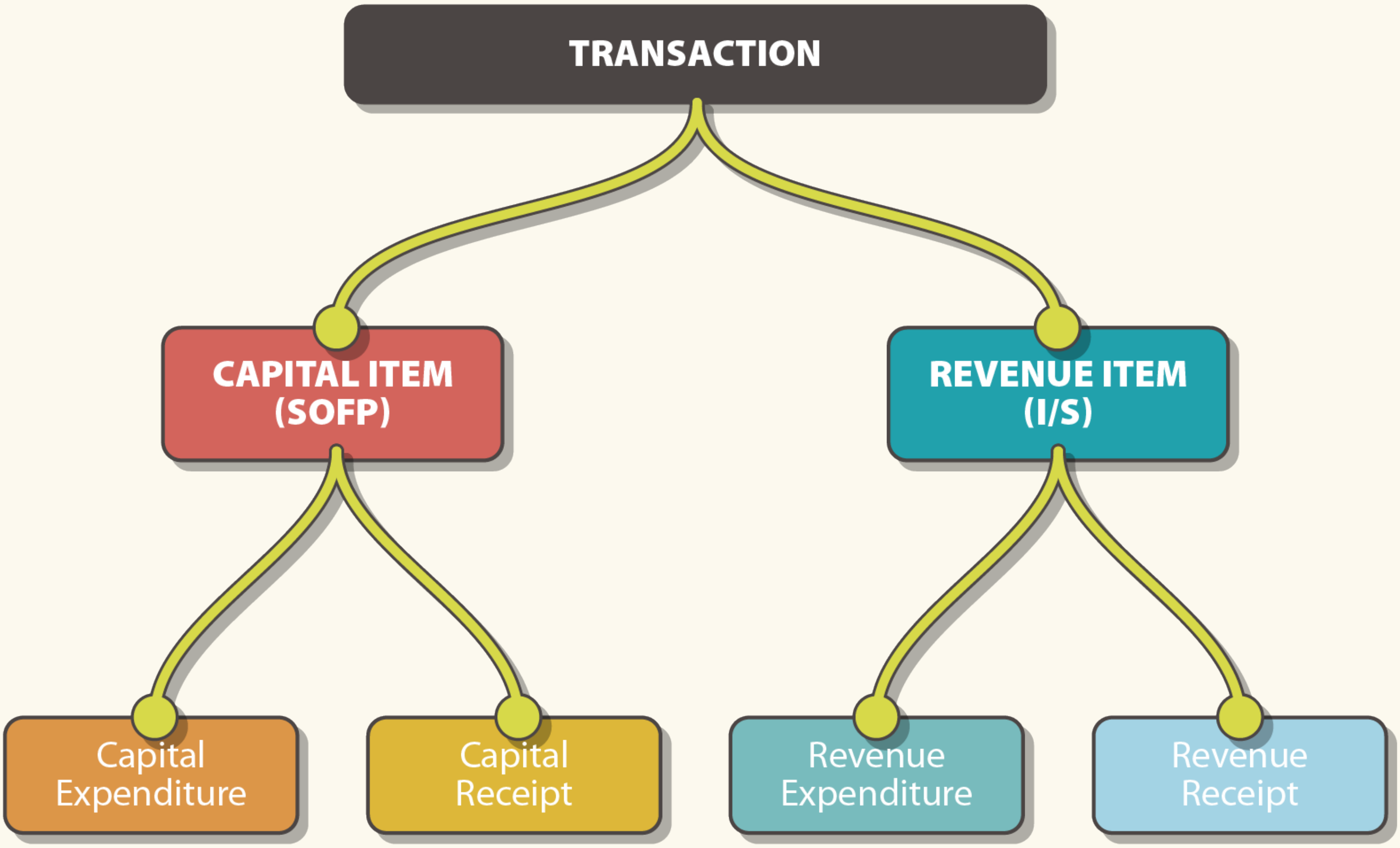
The difference between current and non-current assets

Current assets are assets

- realized (sold/consumed) in entities’ normal operating cycle
- which are held for trading
- which include cash and cash equivalent
- are expected to realize within 12 months after the end of the reporting period

current assets	non-current assets
1. realized within normal operating cycle of entity	1. not realized in normal operating cycle
2. intended for sale or consumption	2. intended for use over a long period of time
3. used for trading purposes	3. used for investment and productive purposes
4. realized within 12 months	4. held for more than 12 months
5. e.g. inventory, cash and bank balance, raw material, receivables	5. e.g. plant and machinery, equipment, land and buildings, office furniture.

Capital and revenue items



nature of transaction	meaning
capital expenditure	i. it increases the value of non-current assets ii. it improves the earning capacity of an asset iii. e.g. purchase of computers, vehicles, building, land, plant and machinery; stamp duty, registration fees, solicitor's fees, architect's fees, installation charges; fitting of air conditioner in vehicles
revenue expenditure	i. it is incurred to maintain existing capacity of asset ii. regular expenditure iii. e.g. repairs and maintenance to machinery, electricity cost for machinery, spare parts for machinery
capital receipt	i. it is income which is not earned out of the regular operations of an entity, i.e. not realized by the sale of the merchandise of the entity ii. it is a receipt earned when an item of capital expenditure is sold iii. it decreases the value of non-current assets
revenue receipt	i. it is a regular receipt/income ii. it decreases current assets iii. it is a result of the sale of the entity's merchandise and other revenue items such as rent received or commission received

Capital expenditure results in the appearance of a non-current asset in the statement of financial position of the business.

Revenue expenditure results in an expense in the statement of profit or loss.

Classify expenditure

Capital expenditure results in the appearance of a non-current asset in the statement of financial position of the business.

Revenue expenditure results in an expense in the statement of profit or loss.

Acquisition and disposal of non-current assets

Acquisition of Non Current Assets

When a non-current asset is acquired, the double-entry is: -

Dr Non-Current Asset
Cr Cash/Payables

Tangible non-current assets should initially be recorded at cost.

The cost of an asset includes

1. Purchase price – after deducting trade discounts and rebates and adding duties and non-refundable taxes
2. Cost directly attributable to bring the asset to its location and to make it available for its intended use.

   These include:

   a. Initial delivery and handling costs
   b. Installation and assembly costs
   c. Costs of testing whether the asset is working properly
   d. Professional fees

   The following costs may not be included:

   a) The cost of maintenance contracts
   b) Administration and general overhead costs
   c) Staff training costs
3. Dismantling cost – cost of removing old asset from its place in order to put in the new one

Disposal of non-current assets

When a non-current asset is sold, there is likely to be a profit or loss on disposal. This is the difference between the net sale price of the asset and its net book value at the time of disposal.

If:

Sales proceeds > NBV → profit on disposal
Sales proceeds < NBV → loss on disposal

Accounting Treatment

1. Remove the cost of the asset:

   Dr Disposal account
   Cr Non-current asset

2. Remove the accumulated depreciation charged to date:

   Dr Accumulated depreciation
   Cr Disposal account

3. Account for the sales proceeds:

   Dr Cash
   Cr Disposal account

4. Balance off disposal account to find the profit or loss on disposal.

A profit on disposal is shown in the statement of profit or loss as sundry income, a loss as an expense in the statement of profit or loss.

Profits or losses on disposal

Instead of receiving sales proceeds as cash, a part exchange allowance could be offered against the cost of a replacement asset:

Dr New asset cost
Cr Disposal account

IAS 16 states that the cost of an item obtained through part exchange is the fair value of the asset received.

The part exchange allowance takes the place of proceeds in the disposals account.

Revaluation of a non-current asset

IAS 16 allows entities the choice of two valuation models for its non-current assets – the cost model or the revaluation model.

Each model needs to be applied consistently to all non-current assets of the same 'class'. A class of assets is a grouping of assets that have a similar nature or function within the business. For example, properties would typically be one class of assets, and plant and equipment another. Additionally, if the revaluation model is chosen, the revaluations need to be kept up to date, although IAS 16 is not specific as to how often assets need to be revalued.

When the revaluation model is used, assets are carried at their fair value, defined as 'the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction'.

When a revalued asset is disposed of, any revaluation surplus may be transferred directly to retained earnings, or it may be left in equity under the heading revaluation surplus. The transfer to retained earnings should not be made through the statement of profit or loss

IAS 16 allows (but does not require) entities to make a transfer of the 'excess depreciation' (the extra depreciation which results due to the increased value of the asset) from the revaluation reserve directly to retained earnings.

Accounting treatment

Adjust cost account to revalued amount.

Remove accumulated depreciation charged on the asset to date.

Put the balance to the revaluation reserve.

The required double-entry is:

Dr Non-current asset cost
Dr Accumulated Depreciation
Cr Revaluation Reserve

Non-current asset balances and movements

For each class of property, plant, and equipment , disclose

basis for measuring carrying amount

depreciation method(s) used

useful lives or depreciation rates

gross carrying amount and accumulated depreciation and impairment losses

reconciliation of the carrying amount at the beginning and the end of the period, showing

o additions
o disposals
o acquisitions through business combinations
o revaluation increases or decreases
o impairment losses
o reversals of impairment losses
o depreciation
o net foreign exchange differences on translation
o other movements

If property, plant, and equipment is stated at revalued amounts, certain additional disclosures are required

> the effective date of the revaluation
>
> whether an independent valuer was involved
>
> the methods and significant assumptions used in estimating fair values
>
> for each revalued class of property, the carrying amount that would have been recognised had the assets been carried under the cost model

the revaluation surplus, including changes during the period and any restrictions on the distribution of the balance to shareholders

	land & building **$**	machinery **$**	office equipment **$**	total **$**
cost or valuation				
at 1 january 2010	50000	10000	8000	68000
revaluation surplus	12000	2000	2000	16000
additions in year	4000	4000	----	8000
disposals in year	-1000	-1000	----	-2000
	--------	--------	--------	--------
at 31 december 2010	65000	15000	10000	90000
	=====	=====	=====	=====
depreciation				
at 1 january 2010	16000	6000	4000	26000
charge for year	4000	3000	2000	9000
eliminated on disposals	-500	-500	----	-1000
	--------	--------	--------	--------
at 31 december 2010	19500	8500	6000	34000
	=====	=====	=====	=====

carrying amount				
at 31 december 2010	45500	6500	4000	56000
	=====	=====	=====	=====
at 1 january 2010	34000	4000	4000	42000

Asset register

An asset register is used to record all non-current assets and is an internal check on the accuracy of the nominal ledger. For example, an asset may have been scrapped and the asset register updated, but the asset has not yet been written off in the accounting records.

In an asset register, the following details about each non-current asset are found: -

· Purchase date
· Cost depreciation method
· Estimated useful life
· Carrying amount
· Description of asset
· Location of asset
· Internal reference number
· Manufacturer's seriel number

Depreciation

Purpose of depreciation

Where assets held by an enterprise have a limited useful life, it is necessary to apportion the value of an asset used in a period against the revenue it has helped to create. Therefore, with the exception of land held on freehold or very long leasehold, every non-current asset has to be depreciated.

A charge is made in the statement of profit or loss to reflect the use that is made of the asset by the business. This charge is called depreciation. The need to depreciate non-current assets arises from the accrual assumption. If money is spent on an asset, then the amount must be charged against profits.

Some key terms

Depreciation: - the allocation of the depreciable amount of an asset over its estimated useful life.

Useful life: - the period over which a depreciable asset is expected to be used by the enterprise; or the number of production or similar units expected to be obtained from the asset by the enterprise.

Depreciable amount: - cost/revalued amount – residual value

Residual value: - the amount the asset is expected to be sold for at the end of its useful life. It is also known as scrap value

Straight line and reducing balance methods

Main methods

There are two main methods for calculating depreciation

> Straight line method
>
> Reducing balance method

Straight line method

The depreciation charge is the same every year.

Formula

Cost of asset – residual value

Expected useful life of asset

OR

(Cost – Residual value) × %

This method is suitable for assets which are used up evenly over their useful life, e.g. fixtures and fittings in the accounts

department.

Reducing balance method

This method is suitable for those assets which generate more revenue in earlier years than in later years; for example machinery in a factory where productivity falls as the machine gets older.

Under this method the depreciation charge will be higher in the earlier years and reduce over time.

Formula

Depreciation rate (%) × Net Book Value (NBV)

Net book value (NBV) / Carrying value = cost – accumulated depreciation to date

This method ignores residual value, since the NBV under this method will never reach zero.

Different methods of appropriate depreciation

It is up to the business to decide which method of depreciation to apply to its non-current assets. The chosen method of depreciation should be applied consistently from year to year. This is an instance of the fundamental accounting assumption of consistency.

The depreciation method has to be reviewed. If there are any changes in the expected pattern of use of the asset, then the method used should be changed. In such cases, the remaining net book value is depreciated under the new method, i.e. only current and future periods are affected. The change is prospective.

Recording Depreciation

Depreciation expense and accumulated depreciation are recorded in ledger accounts

Depreciation has a dual effect which needs to be accounted for

> It reduces the value of the asset in the statement of financial position.
>
> It is an expense in the statement of profit or loss.

The double-entry for depreciation is:

Dr Depreciation expense (I/S)
Cr Accumulated Depreciation (SOFP)

with the depreciation charge for the period.

Change in useful life.

The useful life of an item of property, plant and equipment should be reviewed at least every financial year-end and, if expectations are significantly different from previous estimates, the depreciation charge for current and future periods should be revised.

This is achieved by writing the net book value off over the asset's revised remaining useful life.

NBV – residual value

Revised useful life

Intangible non-current assets and amortisation

Difference between tangible and intangible

The difference between tangible and intangible non-current assets

Tangible non-current assets are defined as those which

1. are held for use in the production or supply of goods or services for administrative purposes; and
2. are expected to be used during more than one period.

An intangible non-current asset is an identifiable, non-monetary asset without physical substance.

Types of intangible assets

Examples of intangible assets

- Development expenditure
- Goodwill
- Concessions, patents, licences, trade marks, copy rights
- Computer software

Paper F3 only requires the accounting treatment of research and development expenditure

Research costs and development costs

Research and Development Expenditure

Many businesses in the commercial world spend vast amounts of money, on an annual basis, on the research and development of products and services. These entities, including pharmaceutical and motor companies, do this with the intention of developing a product or service that will, in future periods, provide significant amounts of income for years to come.

Definitions

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

An example of research could be a company in the pharmaceuticals industry undertaking activities or tests aimed at obtaining

new knowledge to develop a new vaccine. The company is researching the unknown, and therefore, at this early stage, no future economic benefit can be expected to flow to the entity.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems, or services, before the start of commercial production or use.

An example of development is a car manufacturer undertaking the design, construction, and testing of a pre-production model.

Accounting Treatment of Research and Development

IAS 38, Intangible Assets, separates a research and development project into a research phase and a development phase.

Research phase

It is impossible to demonstrate whether or not a product or service at the research stage will generate any probable future economic benefit. As a result, IAS 38 states that all expenditure incurred at the research stage should be written off to the statement of profit or loss as an expense when incurred, and will never be capitalised as an intangible asset.

Development phase

Under IAS 38, an intangible asset must demonstrate all of the following criteria:

> **P**robable future economic benefits
>
> **I**ntention to complete and use or sell the asset
>
> **R**esources (technical, financial and other resources) are adequate and available to complete and use the asset
>
> **A**bility to use or sell the asset
>
> **T**echnical feasibility of completing the intangible asset (so that it will be available for use or sale)
>
> **E**xpenditure can be measured reliably

If any of the recognition criteria are not met then the expenditure must be charged to the statement of profit or loss as incurred.

Note that if all the recognition criteria have been met, capitalisation must take place:

Dr Intangible non-current assets (SOFP)
Cr Bank/Payables

Amounts to be capitalised
Purpose of amortisation

Treatment of Capitalised Development Costs

Once development costs have been capitalised, the asset should be amortised in accordance with the accruals concept over its finite life.

What is amortization?

A tangible non-current asset, e.g. machinery, is capitalised and then depreciated over its useful life. Similarly, the cost of the development expenditure should be amortised over the useful life. Therefore, the cost of the development expenditure is matched against the revenue it produces.

Amortisation must only begin when the asset is available for use (hence matching the income and expenditure to the period in which it relates). It is an expense in the statement of profit or loss: -

Dr Amortisation expense (I/S)
Cr Accumulated amortization (SOFP)

Each development project must be reviewed at the end of each accounting period to ensure that the recognition criteria are still met. If the criteria are no longer met, then the previously capitalised costs must be written off to the statement of profit or loss immediately.

If the intangible asset is considered to have an indefinite useful life, it should not be amortised but should be subjected to an annual impairment review, i.e. check wehter there has been a fall in the value of the intangible asset.

Charge for amortisation
Disclosure notes

Disclosure note for intangible non-current assets

For each class of intangible asset, disclose

useful life or amortisation rate

amortisation method

gross carrying amount

accumulated amortisation and impairment losses

line items in the statement of profit or loss in which amortisation is included

reconciliation of the carrying amount at the beginning and the end of the period showing:

- o additions (business combinations separately)
- o assets held for sale
- o retirements and other disposals
- o revaluations
- o impairments
- o reversals of impairments
- o amortisation
- o foreign exchange differences
- o other changes

basis for determining that an intangible has an indefinite life

description and carrying amount of individually material intangible assets

certain special disclosures about intangible assets acquired by way of government grants

information about intangible assets whose title is restricted

contractual commitments to acquire intangible assets

Additional disclosures are required about

intangible assets carried at revalued amounts

the amount of research and development expenditure recognised as an expense in the current period

DEVELOPMENT EXPENDITURE

	$
Net Book Value at 1 April 20X0	X
Additions	X
Amortisation Charge	(X)
Disposals	(X)
Net Book Value at 31 March 20X1	X

AT 31 MARCH 20X0	$
Cost	X
Accumulated Amortisation	(X)
Net Book Value	X

AT 31 MARCH 20X1	$
Cost	X
Accumulated Amortisation	(X)
Net Book Value	X

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Accruals and prepayments

Matching concept

We have mentioned that one of the underlying assumptions in the “Framework for the Preparation and Presentation of Financial Statements” is the accruals concept. It is also known as the matching concept because of the way it strives to match costs against the revenues generated by incurring those costs.

Its basic tenet is that revenues should be recognised (i.e. included in the statement of profit or loss) in the period in which they are earned, not necessarily when they are received in cash. Thus, for example, a sale made to a customer on credit just before the

year-end would be included in that year's statement of profit or loss, even though the cash may not be received until the following year.

In the same way, expenses are recognised according to the period to which they relate, and not when they are paid. For example, an electricity bill not paid by the year-end would still be charged in that year's statement of profit or loss whereas rates paid in advance would be held back and not charged until the next year

Adjustments needed

Accrued expenses

Accrued expenses (accruals) are expenses which relate to an accounting period but have not been paid for. They are expenses which are charged against the profit for a particular period, even though they have not yet been paid for.

Accruals are included in payables as current liabilities as they represent liabilities which have been incurred but for which no invoice has yet been received.

Accounting Treatment: Accruals

Dr Expense (I/S)
Cr Accruals (SOFP)

Prepaid expenses

Prepaid expenses (prepayments) are expenses which have already been paid but relate to a future accounting period. Therefore, these are payments which have been made in one accounting period, but should not be charged against profit until a later period, because they relate to that later period.

Prepayments are included in receivables in current assets in the statement of financial position. They are assets as they represent money that has been paid out in advance of the expense being incurred.

Accounting Treatment: Prepayments

Dr Prepayments (SOFP)
Cr Expense (I/S)

Reversal of Acrruals and Prepayments

Reversal of Accruals and Prepayments

Accruals and prepayments brought forward at the beginning of the year must be reversed.

Five steps are involved

1. At the beginning of the year, reverse opening accrual or prepayment
2. Double-entry: -

   1. Reversal of an accrual

   Dr Accruals (SOFP)
   Cr Expense (I/S)

   2. Reversal of a prepayment

   Dr Expense (I/S)
   Cr Prepayment (SOFP)

3. Post the cash paid during the year
4. Post any closing accrual or prepayment
5. Balance off the expense and accruals/prepayments accounts

Accrued and deferred Income.

An entity will accrue income when it has earned the income during the period but it has not yet been invoiced or received. This will increase income in the statement of profit or loss and be shown as a receivable in the statement of financial position at year end.

Accounting Treatment: Accrued Income

Dr Accrued income (SOFP)
Cr Income Account (I/S)

When an entity has received income in advance of it being earned, it should be deferred to the following period. This will reduce income in the statement of profit or loss and be shown as a payable in the statement of financial position at the year end.

Accounting Treatment: Deferred Income

Dr Income Account (I/S)
Cr Deferred Income (SOFP)

Impact on profit and net assets

	effect on income/expenses	effect on profit	effect on assets/liabilities
accruals	increases expenses	reduces profit	increases liabilities
prepayments	reduces expenses	increases profit	increases assets
prepayments of income	reduces income	reduces profit	increases liabilities
income accrued	increases income	increases profit	increases assets

Receivables and payables

Offering credit facilities to customers

The benefits and costs

Today, very few businesses expect to be paid immediately in cash. Most businesses buy and sell to one another on credit terms. A business will allow credit terms to customers and receive credit terms from its suppliers. This provides the benefit of allowing businesses to keep trading without having to provide cash 'up front'.

However, providing credit facilities to customers can lead to problems. Customers might fail to pay, either out of dishonesty or because they have gone bankrupt. Therefore, the costs of offering credit facilities to customers can include:

> Interest costs of an overdraft, if customers do not pay promptly.
>
> Costs of trying to obtain payment, e.g. chasing customers by phone

Court costs, e.g. the costs of legal letters

Aged receivables analysis

A tool to control these problems of providing credit facilities is the aged receivables analysis. This shows how long invoices have been outstanding, current, 30 days, 60 days, 90 and 90+ days, and may also indicate that a customer is unable to pay. Most credit controllers will have a system of chasing up payment for long outstanding invoices.

The purpose of credit limits

Another tool in credit control is the credit limit. A customer will be given a credit limit, which cannot be exceeded. This is a threshold that a company will allow its customers to owe at any one time without having to go back and review their credit file. Credit limit is the maximum amount that a firm is willing to risk in an account.

Write off an irrecoverable debt

Irrecoverable debts (bad debts) are specific debts owed to a business which it decides are never going to be paid. If a debt is definitely irrecoverable, the prudence concept dictates it should be written off to the statement of profit or loss as a bad debt.

The value of outstanding receivables must be reduced by the amount written off. This is because the customers are no longer expected to pay, and it would be misleading to show them in the statement of financial position as current assets of the business for which cash payment is expected within one year.

Accounting treatment

Dr Bad debts expense (I/S)
Cr Trade Receivables (SOFP)

An irrecoverable debt recovered

An irrecoverable debt which has been written off might occasionally be unexpectedly paid. If it is paid in the same accounting period, the write-off journal can simply be reversed. The only accounting problem to consider is when a debt written off as irrecoverable in one accounting period is subsequently paid in a later accounting period. In this case, the amount paid should be recorded as additional income in the statement of profit or loss of the period in which the payment is received

Accounting Treatment

Dr Cash
Cr Trade Receivables

Dr Trade Receivables
Cr Bad debts recovered (I/S)

Create and adjust an allowance for receivables

Doubtful Debts

If a debt is possibly irrecoverable, an allowance for the potential irrecoverability of that debt should be made

Accounting treatment

Dr Doubtful debt expense (I/S)
Cr Allowance for receivables (SOFP)

This allowance is offset against trade receivables in the statement of financial position.

Types of allowances

There are two types of allowance for receivables

1. Specific allowance – an allowance against a particular receivable
2. General allowance – a percentage allowance based on past experience of irrecoverable debts (e.g. 2% of all outstanding receivables)

Therefore, an allowance for receivables provides for future irrecoverable debts, as a prudent precaution by the business. For both types of allowance for receivables, the double-entry still remains: -

Dr Doubtful debt expense (I/S)
Cr Allowance for receivables (SOFP)

Specific allowance

There are two situations in which a specific allowance previously done is no longer required

> customer pays outstanding amount
>
> customer goes bankrupt

Customer pays outstanding amount

Accounting treatment

Dr Cash (SOFP)
Cr Trade Receivables (SOFP)
Therefore, this will be credited to income in the statement of profit or loss or it will reduce the total expense for bad and doubtful debts.

Dr Allowance for receivables (SOFP)
Cr Doubtful debts expense (I/S)

Customer goes bankrupt

Customer goes bankrupt

Accounting treatment

Dr Allowance for receivables (SOFP)
Cr Trade Receivables (SOFP)

Therefore, no entry is posted in the bad and doubtful debts account as this would have already been debited with the expense in the first year when we have taken the specific allowance.

Movements in allowance for receivables

How do we calculate the general allowance?

There are a number of steps which must be followed.

1. Take the balance on the trade receivables account after posting credit sales and cash received from credit customers
2. Deduct bad debts from this balance of trade receivables
3. Deduct also any specific allowances from trade receivables
4. Calculate the general allowance by applying the percentage given to the remaining balance

Example: - General allowance

	$
trade receivables (net of bad debts written off)	10000
less: specific allowance	(2000)

	8000

	--------
general allowance @ 2% (2% x 8,000)	160
	=====

General allowance – subsequent years

In subsequent years, adjustments may be needed to the amount of the allowance. The procedure to be followed then is

1. Calculate the new allowance required.
2. Compare it with the existing balance on the allowance account (i.e. the balance b/f from the previous accounting period).
3. Calculate increase or decrease required.

   (i) If a higher allowance is required now:

   Dr Irrecoverable debts expense
   Cr Allowance for receivables
   with the amount of the increase.

   (ii) If a lower allowance is needed now than before:

   Dr Allowance for receivables
   Cr Irrecoverable debts expense

   with the amount of the decrease.

Supplier statements

Provisions and contingencies.

Provisions.

A provision is a liability of uncertain timing or amount.

IAS 37 requires a provision be recognised when all of the following apply:

1. an entity has a present obligation (legal or constructive) as a result of a past event

2. it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation

3. a reliable estimate can be made of the amount of the obligation

Therefore, a provision is made for something which will probably happen. It should be recognised when it is probable that a transfer of economic events will take place and when its amount can be estimated reliably.

Provisions can be distinguished from other liabilities (e.g. trade payables and accruals) due to the uncertainty concerning the timing or amount of the future expenditure required in settlement. In contrast, trade payables are liabilities to pay for goods that have been received and invoiced, hence the timing and amount of the expenditure is agreed with the supplier.

A provision is accounted for as follows: -

Dr Expense (I/S)
Cr Provision (SOFP)

The required provision will be reviewed at each year end and increased or decreased as necessary.

To increase a provision:

Dr Expense (I/S)
Cr Provision (SOFP)

To decrease a provision:

Dr Provision (SOFP)
Cr Expense (I/S)

Measurement of Provision

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period.

Provisions for one-off events (restructuring, environmental clean-up, settlement of a lawsuit) are measured at the most likely amount.

Provisions for large populations of events (warranties, customer refunds) are measured at a probability-weighted expected value.

Worked out example

A company sells goods with a warranty for the cost of repairs required in the first 2 months after purchase.

Past experience suggests:

- 88% of the goods sold will have no defects
- 7% will have minor defects
- 5% will have major defects

If minor defects were detected in all products sold, the cost of repairs will be $24,000; if major defects were detected in all products sold, the cost would be $200,000.

What amount of provision should be made?

(88% x 0) + (7% x 24,000) + (5% x 200,000) = $11,680.

Disclosure note

For each class of provision, an entity should disclose

> the net book value at the beginning and the end of the period
>
> additional provisions made in the period, including increases to existing provisions
>
> amounts utilised during the period
>
> unused amounts reversed during the period

An entity should also disclose, for each class of provision

> a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits
>
> an indication about the uncertainties about the amount and timing of those outflows
>
> the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement

Contingent liability.

Contingent liabilities are

1. possible obligations that arise from past events and whose existence will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the entity
2. present obligations that arise from past events but are not recognised because:

   i. they are not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

   ii. the amount of the obligation cannot be measured with sufficient reliability

Recognition

Contingent liabilities should not be recognized in financial statements but they should be disclosed, unless the possibility of any outflow is remote.   The required disclosures are:

> A brief description of the nature of the contingent liability;
>
> An estimate of its financial effect;
>
> An indication of the uncertainties that exist relating to the amount or timing of any outflow; and
>
> The possibility of any reimbursement.

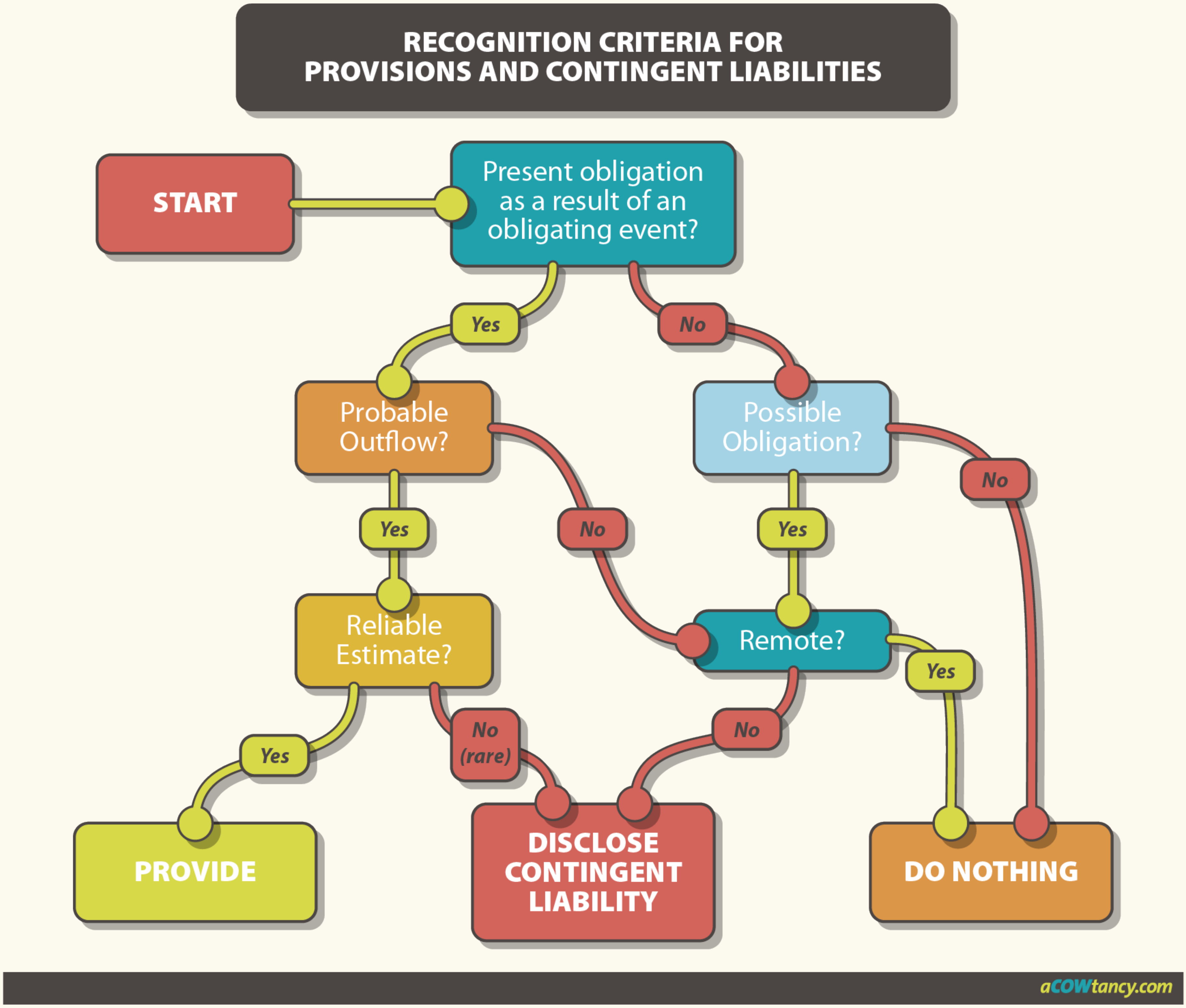
Disclosure Note

Unless the possibility of any outflow is remote, for each class of contingent liability, an entity should disclose at the end of the reporting period, a brief description of the nature of the contingent liability and where practicable

an estimate of its financial effect

an indication of the uncertainties relating to the amount or timing of any outflow; and

the possibility of any reimbursement



Contingent asset.

Contingent assets are possible assets that arise from past events and whose existence will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the entity.

A contingent asset must not be recognized. Only when the realization of the related economic benefits is virtually certain should recognition take place. At that point, the asset is no longer a contingent asset!

Contingent assets must only be disclosed in the notes if they are probable. A brief description of the contingent asset must be provided together with an estimate of its financial effect and details of any uncertainties

Disclosure Note

Where an inflow of economic benefits is probable (contingent asset), an entity should disclose a brief description of the nature of the contingent assets at the end of the reporting period and, where practicable, an estimate of their financial effect.

Capital structure and finance costs

Introduction

Fundamental differences

There are some fundamental differences between the accounts of sole traders and partnerships and limited liability companies. The following are perhaps the most significant.

1. Legislation governing the activities of limited liability companies tends to be very extensive. It may specify that the annual accounts of a company must be filed with a government bureau and so available for public inspection; and they often contain detailed requirements on the minimum information which must be disclosed in a company's accounts. Also, the financial statements of companies must be audited annually.
2. The owners of a company (its shareholders) may be very numerous. Their capital is shown differently from that of a sole trader; and similarly the 'appropriation account' of a company is different.
3. The liability for the debts of the business in a sole trader or partnership is unlimited, which means that if the business runs up debts that it is unable to pay, the proprietors will become personally liable for the unpaid debts, and would be required, if necessary, to sell their private possessions in order to repay them. On the other hand, limited liability companies offer limited liability to their owners. Limited liability means that the maximum amount that an owner stands to lose in the event that the company becomes insolvent and cannot pay off its debts, is his share of the capital in the business.

Capital structure - limited liability company

Capital structure of a limited liability company

The owners' capital in a limited liability company consists of share capital. When a company is originally set up, it issues shares. These are paid for by investors, who then become shareholders of the company. Shares are issued in units of 10 cents, 25 cents, 50 cents, $1 or even $2. The 'face value' of the shares is called their par value or nominal value, e.g. 100,000 shares of $1 each par

50 cents, $1 or even $2. The 'face value' of the shares is called their par value or nominal value, e.g. 100,000 shares of $1 each par value were issued at $1 each.

However, shares may be issued at a price higher than their par value, e.g. the company may issue 20,000 shares of $1 each at $1.25 per share. This excess over the par value is called share premium.

1. Authorised capital is the maximum amount of share capital that a company is empowered to issue. The amount of authorised share capital can change by agreement. For example, a company's authorised share capital might be 10,000,000 ordinary shares of $1 each.
2. Issued capital is the amount at nominal value of share capital that has been issued to shareholders. This amount of issued share capital cannot exceed the amount of authorised capital. Therefore, the company with authorised share capital of 10,000,000 ordinary shares of $1 might have issued 6,000,000 shares. It may issue 4,000,000 more shares at some time in the future.
3. Called-up capital. When shares are issued, a company may not always be paid the full amount for the shares at once. It might call up only a part of the issue price, and wait until a later time before it calls up the remainder. For example, if a company issues 6,000,000 ordinary shares of $1, it might call up only, say, 80 cents per share. Although the issued share capital would be $6,000,000, the called-up share capital would only be $4,800,000.
4. Paid-up capital. When capital is called up, some shareholders might delay their payment (or even default on payment). Paid-up capital is the amount of called-up capital that has been paid. For example, if a company issues 6,000,000 ordinary shares of $1 each, calls up 80 cents per share, but only receives payments of $3,600,000, the capital not yet paid up would be $1,200,000 (4,800,000 – 3,600,000)

Ordinary shares.

Ordinary shares carry no right to a fixed dividend but ordinary shareholders are entitled to all profits. In fact, the amount of ordinary dividends fluctuates from year to year.

Ordinary shares normally carry voting rights. Therefore, ordinary shareholders are the effective owners of a company. They own the 'equity' of the business including any reserves of the business. Ordinary shareholders are sometimes referred to as equity shareholders

Preference Shares.

Preference shares carry the right to a final dividend which is expressed as a percentage of their par value: e.g. a 5% $1 preference share carries a right to an annual dividend of 5c.

Preference dividends have priority over ordinary dividends. The managers of a company are obliged to pay preference dividend first. If the preference shares are cumulative, it means that before a company can pay any ordinary dividend it must not only pay the current year's preference dividend, but must also make good any arrears of preference dividends which were not paid in previous years.

Also, preference shareholders have priority over ordinary shareholders to a return of their capital if the company goes into liquidation. However, preference shares do not carry a right to vote.

Preference shares may be either redeemable or irredeemable

Redeemable preference shares

Redeemable preference shares mean that the company will repay the nominal value of those shares at a later date.

For example, 'redeemable 6% $1 preference shares 20X8' means that the company will pay these shareholders $1 for every share they hold on a certain date in 20X8. Redeemable preference shares are treated like loans and are included as non-current liabilities in the statement of financial position.

However, if the redemption is due within 12 months, the preference shares will be classified as current liabilities. Dividends paid (6c per share in our example) on redeemable preference shares are included as a finance costs (added to interest paid) in the statement of profit or loss.

Irredeemable preference shares

Irredeemable preference shares form part of equity and their dividends are treated as appropriations of profit.

Loan notes.

Loan Notes

Limited liability companies may issue loan stock or bonds to raise finance. These are non-current liabilities but are different from share capital

1. Shareholders are the owners of a company, while providers of loan capital are creditors of the company.
2. Shareholders receive dividends whereas loan holders are entitled to a fixed rate of interest every year. This interest is an expense in the statement of profit or loss and is calculated on the par value, regardless of its market value.
3. Loan holders have to be paid interest when due. Otherwise, they can take legal action against the company if their interest is not paid. Therefore, loan stock is generally less risky than shares.

Share capital and share premium
Other reserves

Other reserves which appear in the company SFP

When describing ordinary shareholders, we have said that these own the ‘equity’ of the business including any reserves. Shareholders' equity consists of

- Share capital (at nominal value)
- Share premium – the difference between the issue price of the share and its par value
- Revaluation surplus – a non-distributable reserve representing unrealised profits on the revalued assets
- Other reserves – very often, these are revenue reserves which may either have a specific purpose (e.g. asset replacement reserve) or not (e.g. general reserve)
- Retained earnings – these are profits earned by the company and which have been retained by the business, i.e. they have not been paid out as dividends, taxes or transferred to another reserve. This reserve usually increases from year to year as companies do not normally distribute all their profits.

Bonus (capitalisation) issue

A company may wish to increase its share capital without needing to raise additional finance. A bonus issue raises no funds.

A company can make a bonus issue to re-classify some of its reserves as share capital. Any reserve may be re-classified in this way, including a share premium account or other reserve. Therefore, these reserves will be debited and share capital credited. Such a re-classification increases the capital base of the company and gives greater protection to the company’s creditors.

Advantage

- Increases share capital without reducing present shareholders' holdings
- Capitalises reserves, therefore less is available for distribution as dividends

Disadvantages

- Does not increases cash

- If profits fall, the payment of dividends could be jeopardised

Rights issue.

A rights issue is an issue of shares for cash. These shares are usually issued at a discount to the current market price. The 'rights' are offered to existing shareholders, who can sell them if they wish.

Advantages

- Raises cash

- Reserves are available for future dividend distribution

Disadvantages

- If a shareholder sells his rights, he will be losing (diluting) his control in the company

Effects of a bonus issue in SFP

Accounting Treatment

Dr Share Premium
Cr Share Capital

A bonus issue is always done at nominal value.

Effects of a rights issue in SFP

Accounting Treatment

Dr Cash
Cr Share Capital
Cr Share Premium

Record dividends

Dividends are an appropriation of retained earnings to shareholders. They are not an expense in the statement of profit or loss.

Accounting treatment

Dr Retained Earnings (SOFP)
Cr Dividends Payable (SOFP)

Dividends can be paid during the year (interim dividends) or at the end of the year (final dividends). The final dividend will only be accounted for if it has been declared before year end. Otherwise, it will be disclosed as a note to the financial statements

Finance costs

The interest expense incurred on loan stock and bonds will be shown as an expense called 'finance costs' in the statement of profit or loss. We have also seen that dividends paid on redeemable preference shares are also included as finance costs.

Accounting treatment

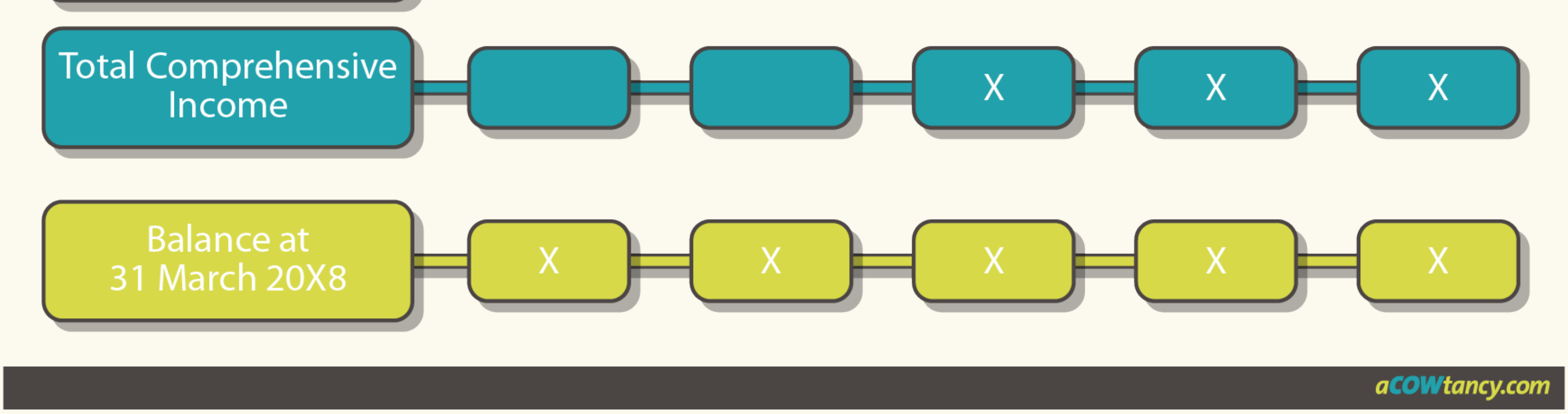
Dr Finance Costs (I/S)
Cr Bank

Statement of changes in equity

The revised statement of changes in equity separates owner and non-owner changes in equity. It includes only details of transactions with owners, with all non-owner changes in equity presented as a single line – total comprehensive income.

Statement of changes in equity – Proforma

	Share Capital '000	Share Premium '000	Revaluation Reserve '000	Retained Earnings '000	Total '000
Balance at 31 March 20X7	X	X	X	X	X
Changes in Accounting Policy				X	X
Restated Balance	X	X	X	X	X
Issue of Share Capital	X	X			X
Dividends				(X)	(X)



Under and overprovision of tax

Preparing a trial balance

Trial balance

The purpose of a trial balance

The entries in each ledger account are then totaled and a balance is found. Balances are usually collected in a trial balance which is then used as a basis for preparing a statement of profit or loss and a statement of financial position.

A trial balance is a list of ledger balances shown in debit and credit columns. It lists the balances on ledger accounts and totals them. Total debits should equal total credits. Therefore, it is a method used to test the accuracy of the double-entry bookkeeping, i.e. the accuracy of the accounting records.

Extract ledger balances
Opening trial balance
Limitations of a trial balance

The limitations of a trial balance

We have seen that the trial balance is a method used to test the accuracy of the accounting records. Therefore, if the two columns of the list are not equal, there must be an error in recording the transactions in the accounts. However, the trial balance will not disclose the following types of errors.

- The complete omission of a transaction, because neither a debit nor a credit is made.
- The posting of a debit or credit to the correct side of the ledger, but to a wrong account.
- Compensating errors (e.g. an error of $500 is exactly cancelled by another $500 error elsewhere).

Errors of principle, e.g. cash from receivables being debited to receivables account and credited to cash at bank instead of the other way round.

These errors will be discussed again in the chapter “Correction of Errors”.

Closing Inventories

A business will purchase goods to sell during the year. It is unlikely that all of these goods will have been sold by the year end. The goods still held at the year end are known as closing inventories. These are an asset of the business and so should be included in the statement of financial position. Also, these inventories will be included in the cost of sales calculation. When a business determines its profit for the year it should match the sales revenue earned to the cost of goods it sold.

The double-entry for closing inventories is: -

Dr Inventories (SOFP)
Cr Closing Inventories (COS)

Closing inventories will be discussed in further detail in the chapter “Inventories”.

Correction of errors

Types of error

Types of error which may occur in bookkeeping systems

The following are five frequent types of error

1. **Errors of transposition**

   Wwhen two digits in an amount are accidentally recorded the wrong way round.

2. **Errors of omission**

Failing to record a transaction at all, or making a debit or credit entry, but not the corresponding double entry.

3. **Errors of principle**

   Making a double entry in the belief that the transaction is being entered in the correct accounts, but subsequently finding out that the accounting entry breaks the 'rules' of an accounting principle or concept.

4. **Errors of commission**

   Where the bookkeeper makes a mistake in carrying out his or her task of recording transactions in the accounts. Two examples are: - putting a debit/credit entry in the wrong account; errors of casting (adding up)

5. **Compensating errors**

   Errors which are, coincidentally, equal and opposite to one another.

Errors corrected by journal entry

Some of these errors can be corrected by journal entry; some require the use of a suspense account.

> If the correction involves a double entry in the ledger accounts, then it is done by using a journal entry in the journal.
>
> When the error breaks the rule of double entry (single entry or error on one side only), then it is corrected by the use of a suspense account as well as a journal entry.

Errors highlighted by trial balance

Errors highlighted by the extraction of a trial balance

Errors that can be detected by a trial balance include

> Errors of transposition
>
> Errors of omission (if the omission is one-sided)

> Errors of commission (for e.g. if one-sided, or two debit entries are made)

Other errors will not be detected by extracting a trial balance, but may be spotted by other controls (such as bank or control account reconciliations).

Journal entries to correct errors

Suspense Accounts

A suspense account is a temporary account. It never appears in the final accounts.

It is used for two main reasons:

1. To account for a debit or credit entry when the accountant is unsure as to where it should go
2. To make a preliminary trial balance balance when an error has been detected.

Steps to clear a suspense account

Determine the original accounting entry which was made.

Decide what entry should have been made.

Make the required adjustment.

Impact of errors

When errors are corrected they may affect the business' profit for the year figure. In order to find the correct figure for profit, a statement of adjustments to profit has to be prepared.

Proforma – Statement of Adjustment to Profit

	$	**$**	**$**
	+	-	
original profit			x
adjustment:			
over depreciation expense charged	x		
unrecorded expense		x	
unrecorded sale	x		
	----	----	
	x	(x)	x
			----
adjusted profit			**x**
			===

Control accounts and reconciliations

Purpose of control accounts

A control account is a total account in the nominal ledger. Its balance represents an asset or a liability which is the grand total of

A control account is a total account in the nominal ledger. Its balance represents an asset or a liability which is the grand total of many individual assets or liabilities. The control accounts provide a convenient total which can be used immediately in extracting a trial balance or preparing accounts.

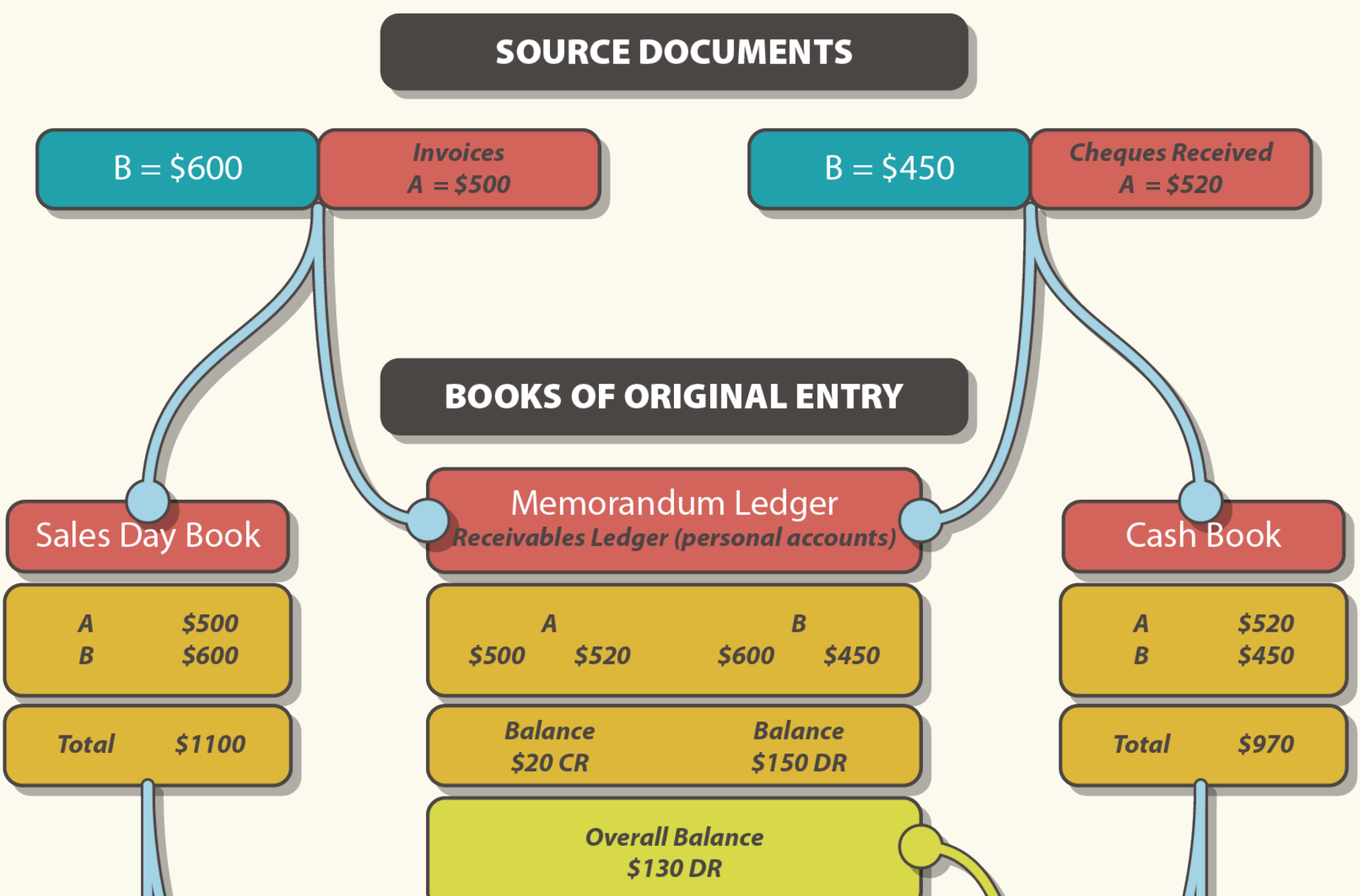
Most businesses operate control accounts for trade receivables and payables, but such accounts may be useful in other areas too, e.g. sales tax control account.

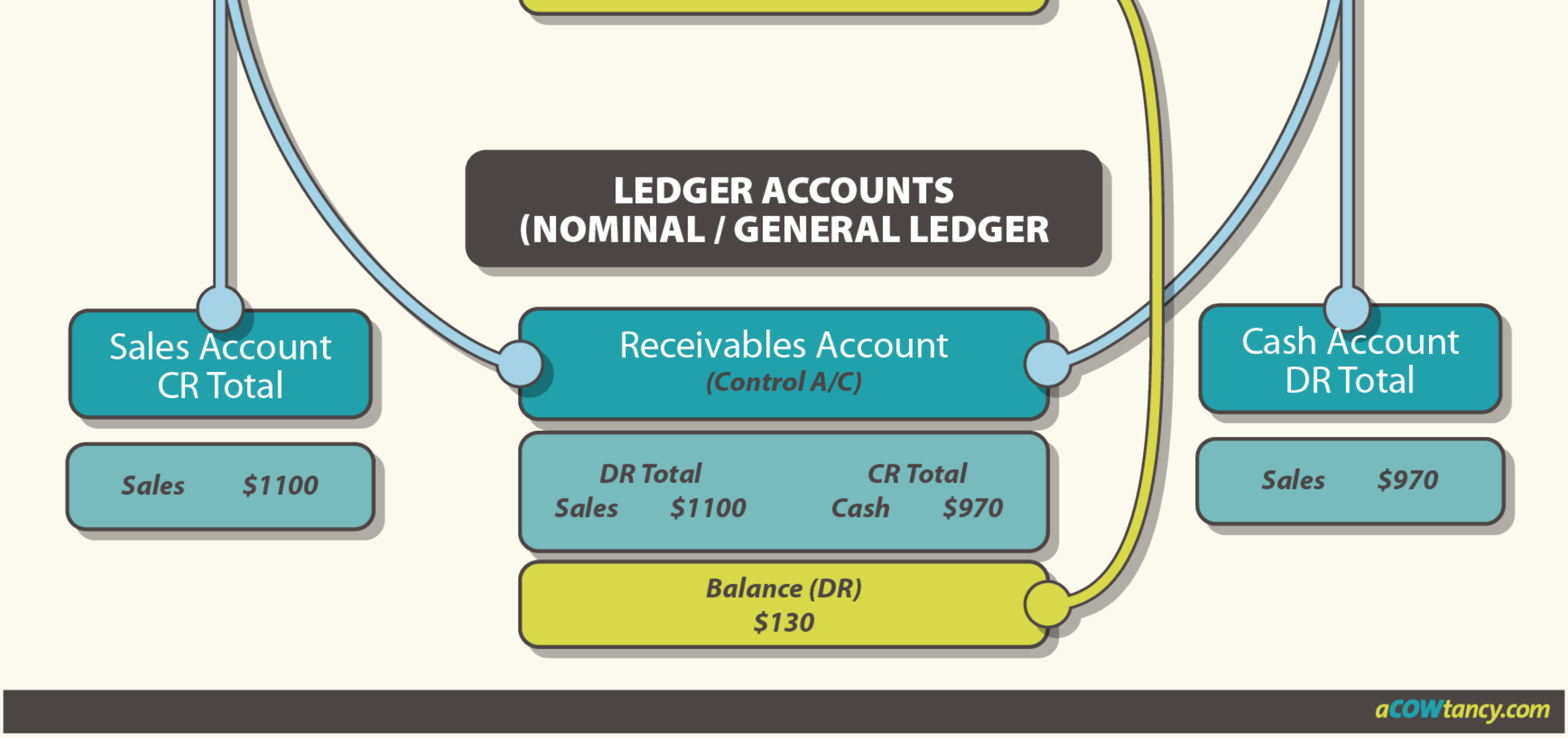
The accounts of individual trade receivables and payables are found in the Receivables Ledger (RL) and Payables Ledger (PL) respectively. These are maintained for memorandum purposes only. Therefore, entering a sales invoice in the account of an individual customer is not part of the double entry process. These individual accounts are necessary for administrative convenience. For example, a customer may wish to query the balance he owes to the business.

Reconciliation between the control account total and the receivables ledger will help to detect errors, thus providing an important control.

Control accounts and double-entry system

In previous topic, we discussed the books of prime entry. We have also looked at the flow of information where we have seen that the totals from the books of prime entry are posted in the nominal accounts using double-entry.





The trade receivables figure shows the total amount owed by all customers at a particular point in time. It is also called the receivables ledger control account (RLCA).

The trade payables figure shows the total amount owed to all suppliers at a particular point in time. It is also called the payables ledger control account (PLCA).

Control accounts from given information

Main entries in control accounts

The two main entries in the RLCA are credit sales and cash received from credit customers.

The double-entry for credit sales is: -

Dr RLCA
Cr Sales

The double-entry for cash received from customers is: -

Dr Bank/Cash
Cr RLCA

The two main entries in the PLCA are credit purchases and cash paid to credit suppliers.

The double-entry for credit purchases is: -

Dr Purchases
Cr PLCA

The double-entry for cash paid to suppliers is: -

Dr PLCA
Cr Bank/Cash

There are other entries which will be included in the control accounts. It is important to note that any transaction recorded in the RLCA or the PLCA is also reflected in the memorandum ledgers.

Other entries in control accounts

Contras

This is where an amount of money is owed to a supplier, who is also a customer who owes money, i.e., a payable who is also a receivable.

Instead of paying the full amount to the creditor, who then pays the full amount of their debt to you, the two amounts owed and owing are offset against each other and only the difference is settled in cash. This must be reflected in the individual accounts in the sales and purchase ledgers and in the control accounts in the nominal ledger.

The double entry for a contra is: -

Dr PLCA
Cr SLCA

The contra value is of the maximum common amount. A contra always has the effect of reducing both receivables and payables.

Returns, Credit Notes and Refunds

When a customer returns goods which have already been paid, he may either be given a credit note or refunded for the value of these returned goods.

When a credit note is given, the double-entry is: -

Dr Returns In (sales returns)
Cr RLCA

When the customer is refunded: -

When the customer is refunded:

Dr RLCA
Cr Bank

The same applies when a customer over-pays an invoice.

Interest charged on overdue accounts

An entity may decide to charge interest if a customer does not pay within the specified credit period.

The double-entry for interest charged on these overdue accounts is: -

Dr RLCA
Cr Interest Receivable (Income (I/S))

Discounts

There are two types of discounts

1. Trade discount is a reduction in the list price of an article, given by a wholesaler or manufacturer to a retailer. It is often given in return for bulk purchase orders.
2. Cash/settlement discount is a reduction in the amount payable for the purchase of goods or services in return for payment in cash, or within an agreed period.

Trade discounts received are deducted from the cost of purchases. Trade discounts allowed are deducted from sales. Therefore, sales are recorded net of trade discounts but inclusive of settlement discounts.

Purchases are also recorded net of trade discounts but inclusive of settlement discounts. Therefore, trade discounts never appear in the financial statements.

Sales Tax and Discounts

Sales tax is calculated on the amount after all discounts, regardless of whether the discount is taken or not.

RECEIVABLES LEDGER CONTROL A/C

Balance B/D	$7,120	Cash Received	$52,450
Sales	$52,500	Discounts Allowed	$1,250
Dishonoured Cheques	$1,000	Returns In	$800
		Irrecoverable Debts	$300
		Balance C/D	$5,820
TOTAL	**$60,620**	**TOTAL**	**$60,620**

PAYABLES LEDGER CONTROL A/C

Cash Paid	$29,840	Balance B/D	$8,300
Discounts Received	$100	Purchases	$31,100
Returns Out	$60		
Balance C/D	$9,400		
TOTAL	**$39,400**	**TOTAL**	**$39,400**

Control account balances

Very often, PLCA's have a credit balance since payables are a liability. However, there may be situations when there will be a debit balance on a PLCA

> Returning goods which have been paid for and receiving a 'credit' (to us, a debit) on our account
>
> Overpayment
>
> Payments in advance

Credit balance on a RLCA

There may be situations when there will be a credit balance on a RLCA

Returned goods credit to account

- Overpayment
- Payments in advance

Control account reconciliation

Both the receivables and payables control accounts should be balanced regularly and the balance agreed to the sum of the balances on the memorandum ledgers, the receivables ledger and the payables ledger respectively.

Therefore, if the balances in the receivables/payables ledgers are added up, they should agree to the RLCA/PLCA balances. If not, an error must have occurred at the same point in the system.

Identify errors
Correct errors

Types of error

Errors which affect the control accounts

> Over/undercast SDB, PDB, CB.
>
> Transposition error in posting total from SDB/PDB/CB to nominal ledger.
>
> Entry omitted from SDB/PDB/CB.

Errors which affect the list of balances (receivables/payables ledger)

> Omit balance from the list
>
> List a debit balance as a credit/vice versa.
>
> Transposition error in filling ledger from books of prime entry.

Errors which affect both the lists of balances and RLCA/PLCA

> Details being incorrectly recorded on the original source documentation i.e. sales/purchase invoice.
>
> Loss of original source documentation so it is not recognised anywhere in the system.

RECEIVABLES LEDGER CONTROL A/C

	$		$
Balance B/D	X	Transposition error in posting	X
Sales Day Book Undercast	X	Balance C/D	X
Sales omitted from SDB	X		
TOTAL	**X**	**TOTAL**	**X**

RECONCILIATION STATEMENT

	+$	-$	$
Total per listing of receivables ledger balances			X
Adjustments:			
Balance omitted	X		
Credit balance listed as debit		2X	
	X	X	X
Balance as per adjusted control account			X

PAYABLES LEDGER CONTROL A/C

	$		$
Transposition error in posting	X	Balance B/D	X
Balance C/D	X	Purchase Day Book Undercast	X
		Purchases omitted from SDB	X

TOTAL	X	TOTAL	X

RECONCILIATION STATEMENT

	+$	-$	$
Total per listing of payables ledger balances			X
Adjustments:			
Balance omitted	X		
Debit balance listed as credit		2X	
	X	X	X
Balance as per adjusted control account			X

Bank reconciliations

Purpose of bank reconciliations

We have already discussed the cash book as one of the main books of prime entry. The cash book is used to record the detailed transactions of receipts and payments affecting the bank account. These are then posted to the nominal ledger periodically. At the end of each accounting period, the balance on the cash book should equal the balance in the nominal ledger cash/bank account.

As an extra control over the cash figure, it should be possible to agree this figure to an independent figure provided by the bank statement. This is not always a straightforward agreement as there are many reasons why the two figures may not be exactly the same. Therefore, we need to produce a reconciliation.

Aim of reconciliation

The aim of the reconciliation is to prove the

> completeness
>
> accuracy
>
> validity

of cash receipts and payments.

Differences between cash book and bank statement

The main reasons for differences between the cash book and the bank statement

The balance on the cash account (which should be the same as the balance in the cash book) is compared to the balance on the bank statements at a given date. However, these two balances may not agree. There are various reasons

1. Time lag between writing a cheque and the payment appearing on the bank statement (unpresented cheques)
2. Time lag between depositing amounts into the bank account and these appearing on the bank statement (unrecorded lodgements)
3. Direct debits and standing orders are not yet recorded in the cash account (or cash book)
4. Bank charges not recorded in the cash account (or cash book)
5. Errors, such as transposition errors, or casting errors in the cash account (or cash book)
6. Errors made by the bank on the bank statement

Differences between the cash book and the bank statement

Therefore, differences between the cash book and the bank statement arise for 3 reasons

Errors – usually in the cash book

Omissions – such as bank charges, standing orders and direct debits not posted in the cash book

Timing differences – such as unpresented cheques and unrecorded lodgements

Always remember

In our cash book,
A debit bank balance indicates an asset

but

In the bank statement,
A debit balance indicates a bank overdraft (we owe money to the bank – an asset for the bank)

In our cash book,

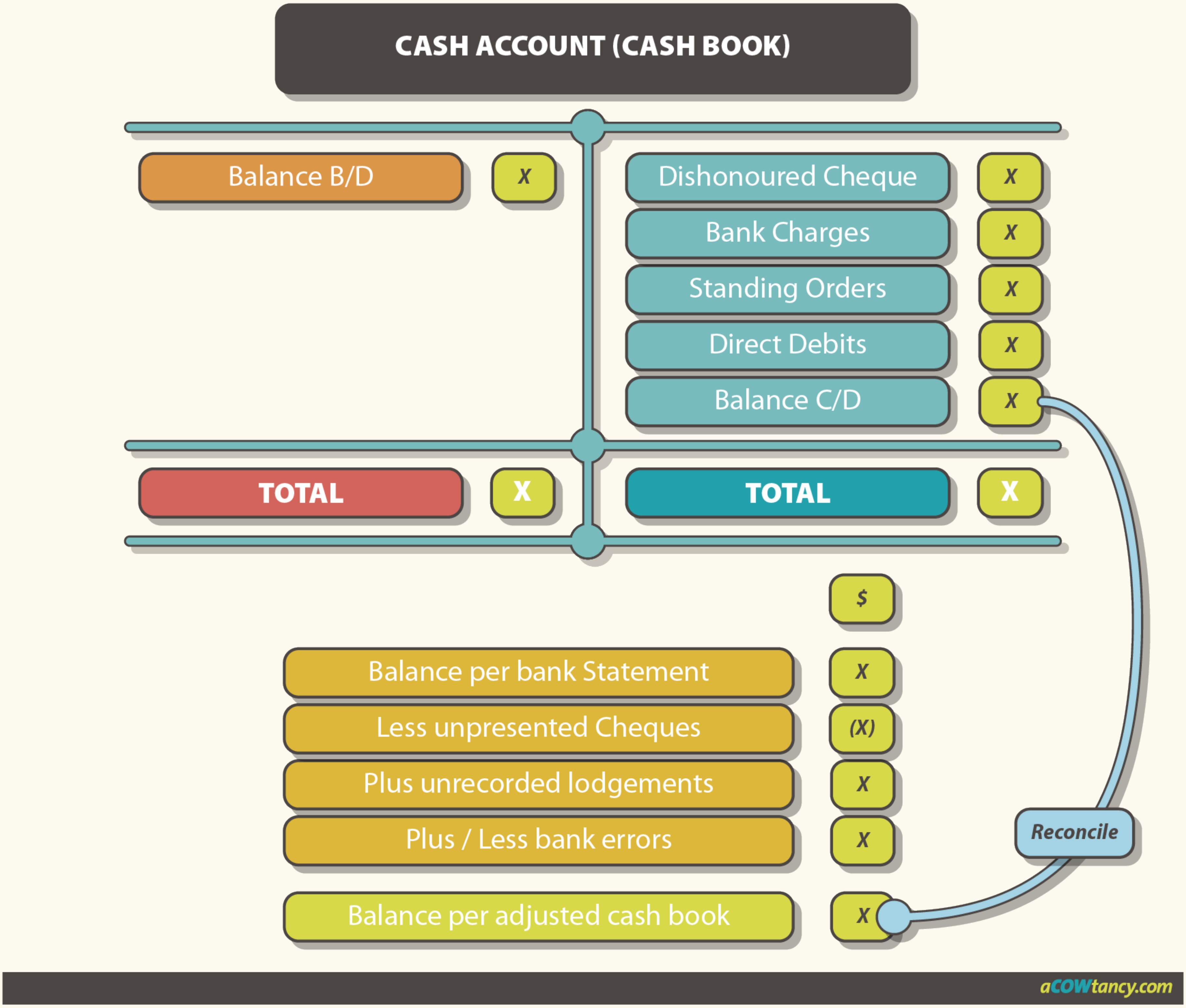
A credit bank balance indicates a liability (overdraft)

but

In the bank statement,

A credit balance indicates a positive balance (the bank owes us money)

Correct cash book errors and/or omissions



Bank reconciliation statement

Suspense accounts

Preparing basic financial statements

Statements of financial position

Statement of financial position.

Statement of financial position.

The accounting equation expresses the statement of financial position as an equation. It emphasises the equality between assets and liabilities (including capital as a liability). In accounting, capital is an investment of money (funds) with the intention of earning a return. A business proprietor invests capital with the intention of earning profit. As long as that money is invested, accountants will treat the capital as money owed to the proprietor by the business. Also, the business entity concept states that, regardless of how a business is legally set up, in accounting a business is always treated separately from its owners(s).

Assets = Liabilities
Assets = (Capital + Profit - Drawings) + Payables
Assets - Payables = Capital + Profit - Drawings
Net Assets = Proprietor's Interest

Example: -

At 1.1.X3 Henry has net assets of $120,000. During the year he puts in capital of $50,000 and draws out $90,000. His net assets at 31.12.X3 are $25,000.

Required:

What is his profit or loss for the year?

Answer: -

Closing Net Assets = Opening Net Assets + Capital Introduced + Profit - Drawings
25,000 = 120,000 + 50,000+ P - 90,000
Loss = 55,000

Extracts of a statement of financial position

The balances on all remaining ledger accounts (including the profit or loss in the statement of profit or loss) can be listed and rearranged to form the statement of financial position. A credit balance brought down denotes a liability. An asset would be represented by a debit balance brought down. The statement of financial position is not part of the double-entry system so the balances are not transferred out.

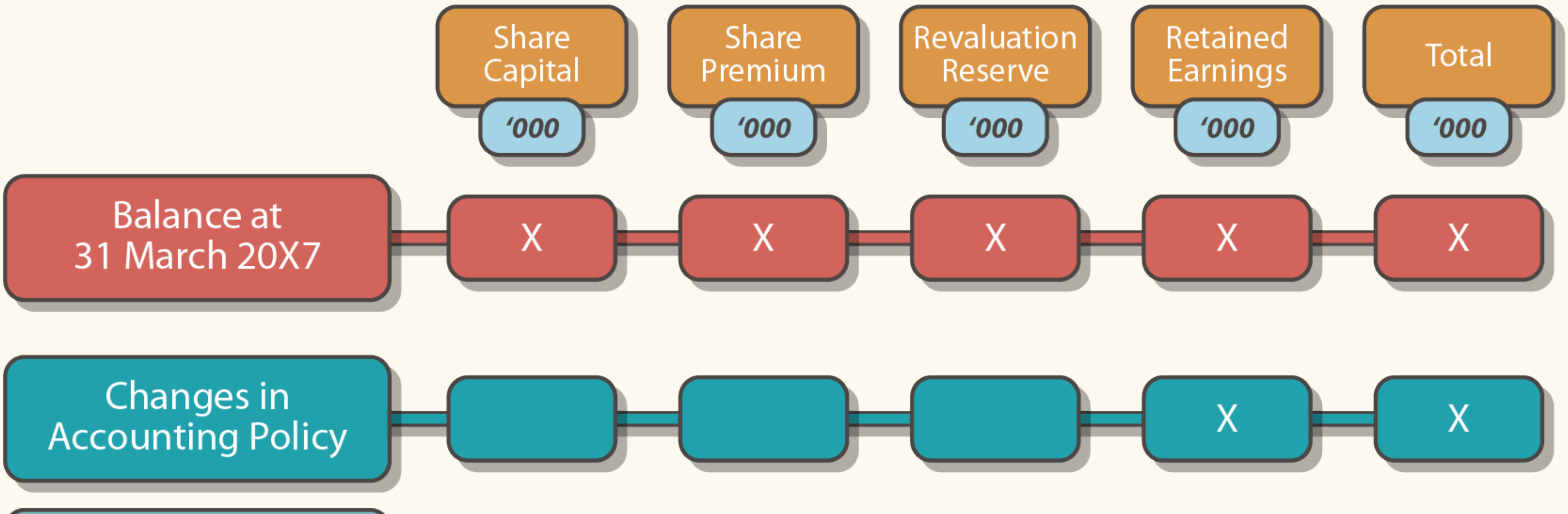
Statements of profit or loss and other comprehensive income

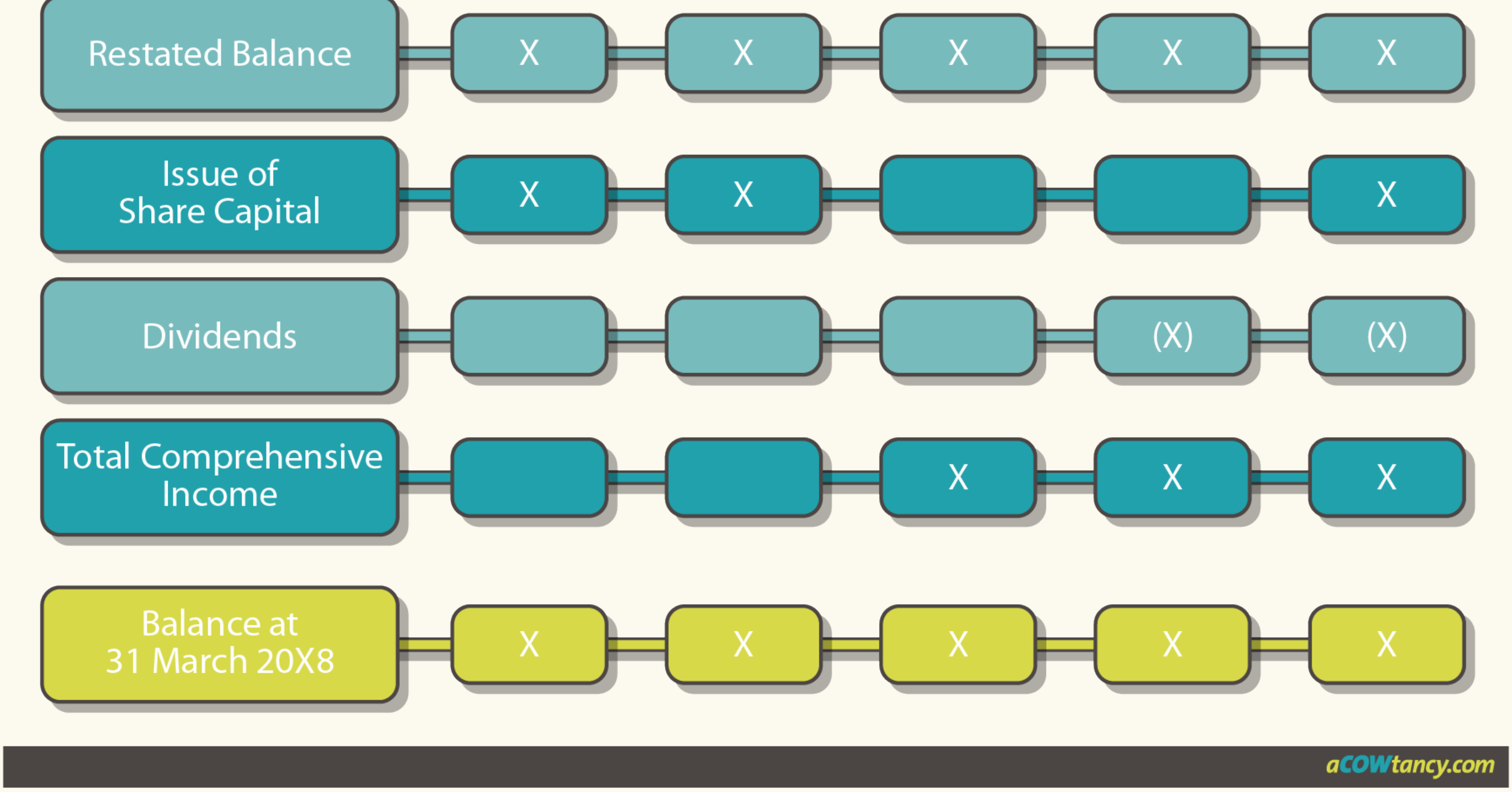
Statement of profit or loss

The first step in the process of preparing the financial statements is to open up another ledger account, called the statement of profit or loss. The balances on all the income and expenditure T-accounts are transferred to the statement of profit or loss and the closing inventory adjustment is made. The statement of profit or loss is part of the double entry system, so the basic rule of double entry still applies: every debit must have an equal and opposite credit entry.

Statement of changes in equity

The revised statement of changes in equity separates owner and non-owner changes in equity. It includes only details of transactions with owners, with all non-owner changes in equity presented as a single line – total comprehensive income.





Disclosure notes

Purpose of disclosure notes

Notes to the accounts

Notes to the accounts are prepared for the following three purposes:

1. present information about the basis of preparation of the financial statements and the specific accounting policies used;
2. disclose the information required by IFRSs that is not presented elsewhere in the financial statements; and
3. provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.

Non current assets including tangible and in tangible assets

Property, Plant and Equipment

For each class of property, plant and equipment, disclose

basis for measuring carrying amount

depreciation method(s) used

useful lives or depreciation rates

gross carrying amount and accumulated depreciation and impairment losses

reconciliation of the carrying amount at the beginning and the end of the period, showing:
o additions
o disposals
o acquisitions through business combinations
o revaluation increases or decreases
o impairment losses
o reversals of impairment losses
o depreciation
o net foreign exchange differences on translation
o other movements

Revalued amounts

If property, plant, and equipment is stated at revalued amounts, certain additional disclosures are required:

the effective date of the revaluation

whether an independent valuer was involved

the methods and significant assumptions used in estimating fair values

for each revalued class of property, the carrying amount that would have been recognised had the assets been carried under the cost model

the revaluation surplus, including changes during the period and any restrictions on the distribution of the balance to shareholders

	land & building	machinery	office equipment	total
	$	$	$	$
cost or valuation				
at 1 january 2010	50000	10000	8000	68000
revaluation surplus	12000	2000	2000	16000
additions in year	4000	4000	---	8000
disposals in year	-1000	-1000	---	-2000
	-------	-------	-------	-------
at 31 december 2010	65000	15000	10000	90000
	=====	=====	=====	=====
depreciation				
at 1 january 2010	16000	6000	4000	26000
charge for year	4000	3000	2000	9000
eliminated on disposals	-500	-500	---	-1000
	-------	-------	-------	-------
at 31 december 2010	19500	8500	6000	34000
	=====	=====	=====	=====
carrying amount				
at 31 december 2010	45500	6500	4000	56000
	=====	=====	=====	=====
at 1 january 2010	34000	4000	4000	42000

at 1 January 2010	**34000**	**4000**	**4000**	**42000**

Intangible non-current assets (IAS 38)

For each class of intangible asset, disclose

useful life or amortisation rate

amortisation method

gross carrying amount

accumulated amortisation and impairment losses

line items in the statement of profit or loss in which amortisation is included

reconciliation of the carrying amount at the beginning and the end of the period showing:

o additions (business combinations separately)
o assets held for sale
o retirements and other disposals
o revaluations
o impairments
o reversals of impairments
o amortisation
o foreign exchange differences
o other changes

basis for determining that an intangible has an indefinite life

description and carrying amount of individually material intangible assets

certain special disclosures about intangible assets acquired by way of government grants

information about intangible assets whose title is restricted

contractual commitments to acquire intangible assets

Additional disclosures

Additional disclosures are required about:

- intangible assets carried at revalued amounts
- the amount of research and development expenditure recognised as an expense in the current period

development expenditure	
	$
net book value at 1 april 20x0	**x**
additions	**x**
amortisation charge	**(x)**
disposals	**(x)**
	----
net book value at 31 march 20x1	**x**
	===
at 31 march 20x0	
cost	**x**
accumulated amortisation	**(x)**
	----
net book value	**x**
	===

at 31 march 20x1	
cost	x
accumulated amortisation	(x)
	----
net book value	x
	===

Provision

Provisions, Contingent Liabilities and Contingent Assets (IAS 37)

provisions	
at 1 april 20x0	x
increase in period	x
released in period	(x)
	----
at 31 march 20x1	x
	===

Contingent liabilities

Contingent liabilities should not be recognized in financial statements but they should be disclosed, unless the possibility of any outflow is remote.   The required disclosures are:

A brief description of the nature of the contingent liability;

An estimate of its financial effect;

An indication of the uncertainties that exist relating to the amount or timing of any outflow; and

Inflow of economic benefits is probable

Where an inflow of economic benefits is probable, an entity should disclose

> a brief description of its nature; and where practicable
>
> an estimate of the financial effect

Events after the reporting periods

IAS 10 requires these three disclosures

1. the date when the financial statements were authorised for issue and who gave that authorisation.
2. if information is received after the end of the reporting period about conditions that existed at the end of the reporting period, disclosures that relate to those conditions should be updated in the light of the new information.
3. where non-adjusting events after the reporting period are of such significance that non-disclosure would affect the ability of the users of financial statements to make proper evaluations and decisions, disclosure should be made for each such significant category of non-adjusting event regarding the nature of the event and an estimate of its financial effect or a statement that such an estimate cannot be made.

Inventories

The financial statements should disclose

- accounting policy for inventories
- carrying amount, generally classified as merchandise, supplies, materials, work in progress, and finished goods. The classifications depend on what is appropriate for the entity
- carrying amount of any inventories carried at fair value less costs to sell
- amount of any write-down of inventories recognised as an expense in the period

Revenue

IAS 18, Revenue, prescribes the requirements for the recognition of revenue arising from an entity's ordinary activities.

Measurement of Revenue

Revenue is to be measured at the fair value of the consideration received or receivable. By fair value, we mean "the amount for which an asset can be exchanged, or a liability settled, between knowledgeable parties in an arm's length transaction."

Generally, revenue is recognized when the entity has transferred to the buyer the significant risks and rewards of ownership and when the revenue can be measured reliably.

Scope

IAS 18 covers the revenue from

- Sale of goods
- Rendering of services

Revenue from the sale of goods

Revenue from the sale of goods should be recognized when all of the following criteria are satisfied

1. The significant risks and rewards of ownership of the goods have been transferred to the buyer
2. The seller retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold
3. The amount of the revenue can be reliably measured
4. It is probable that economic benefits associated with the transaction will flow to the seller
5. The costs incurred or to be incurred in respect of the transaction can be measured reliably

Revenue from the rendering of services

For revenue arising from the rendering of services, revenue should be recognised by reference to the stage of completion of the transaction at the end of the reporting period. The following criteria must be met:

1. the amount of revenue can be measured reliably;
2. it is probable that the economic benefits will flow to the seller;
3. the stage of completion at the balance sheet date can be measured reliably; and
4. the costs incurred, or to be incurred, in respect of the transaction can be measured reliably.

Interest, royalties and dividends

Interest, royalties and dividends are included as income because they arise from the use of an entity's assets by other parties. They are recognised as revenue when the economic benefits are expected to flow to the enterprise and the amount of revenue can be measured reliably.

Revenue does not include sales taxes, value added taxes or any other tax which is collected for third parties.

Events after the reporting period

Event after the reporting period

According to IAS 10, "Events after the reporting period" are those events, both favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue".

These events can have important effects on the financial statements

Adjusting or non-adjusting

Types of events

Two types of events can be identified

1. those that provide evidence of conditions that existed at the end of the reporting period (adjusting events); and
2. those that are indicative of conditions that arose after the end of the reporting period (non-adjusting events).

Examples of adjusting events given in IAS 10 are

the resolution of a court case, as the result of which a provision has to be recognised instead of the disclosure by note of a contingent liability;

evidence of impairment of assets;

bankruptcy of a major customer;

sale of inventories at prices suggesting the need to reduce the figure in the Statement of Financial Position to the net value actually realized;

discovery of fraud or errors that show the financial statements were incorrect

Examples of non-adjusting events given in IAS 10 are

- decline in market value of investments;
- announcement of a plan to discontinue part of the enterprise;
- major purchases and sales of assets;
- destruction of a major asset by fire etc;
- sale of a major subsidiary;
- major dealings in the company's ordinary shares;

Further provisions covered by IAS 10

1. **Authorisation for issue of financial statements**

   An enterprise should disclose the date when the financial statements were authorised for issue and who gave that authorisation. If the owners or others have the power to amend the financial statements after issue, that fact should be disclosed.

2. **Going concern**

   If the management decides after the end of the reporting period that it is necessary to liquidate the enterprise, the financial statements should not be prepared on a going concern basis.

3. **Dividends**

   If an entity declares dividends after the reporting period, the entity shall not recognise those dividends as a liability at the end of the reporting period. That is a non-adjusting event.

Reporting events

How adjusting and non-adjusting events are reported

Financial statements should be adjusted for adjusting events. This means that the amounts in the financial statements should be changed.
Non-adjusting events do not, by definition, require an adjustment to the financial statements, but if they are of such importance that non-disclosure would affect the ability of users of the financial statements to make proper evaluations and decisions, the enterprise should disclose by note:

> the nature of the event; and
>
> an estimate of its financial effect, or a statement that such an estimate cannot be made.

Statements of cash flows (excluding partnerships)

Differences between profit and cash flow

Control cash flow

A business may appear profitable on its statement of profit or loss, however if its cash outflow exceeds its cash inflow over a prolonged period then it will not survive.
Readers of a company's financial statements might also be misled by a reported profit figure.

1. Shareholders might believe that if a company makes a profit after tax, then this is the amount which it could afford to pay as a dividend.
2. Employees might believe that if a company makes profits, it can afford to pay higher wages next year.
3. Survival of a business entity depends not so much on profits as on its ability to pay its debts when they fall due.

Indeed, a business must generate sufficient cash from its operations to reward the various stakeholders e.g., shareholders and lenders. An expanding company might have negative operating cash flow as it builds up the level of its inventories and receivables in line with the increased turnover. However, an increase in working capital without an increase in turnover might indicate operational inefficiencies and will lead to liquidity problems.

Benefits and drawbacks

One of the most useful financial statements produced by a business is the statement of cash flow because it provides a clear and understandable picture of cash movements over the financial year.

A statement of cash flow provides useful additional information that is not provided by the statement of profit or loss. For example, it identifies whether cash has increased or decreased from one year to the next and also where the cash has come from.

Statements of cash flow are a useful addition to the financial statements of a company because accounting profit is not the only indicator of performance. They concentrate on the sources and uses of cash and are a useful indicator of a company's liquidity and solvency.

Also, users of accounts can readily understand cash flows, as opposed to statements of profit or loss and statements of financial position which are subject to manipulation by the use of different accounting policies.

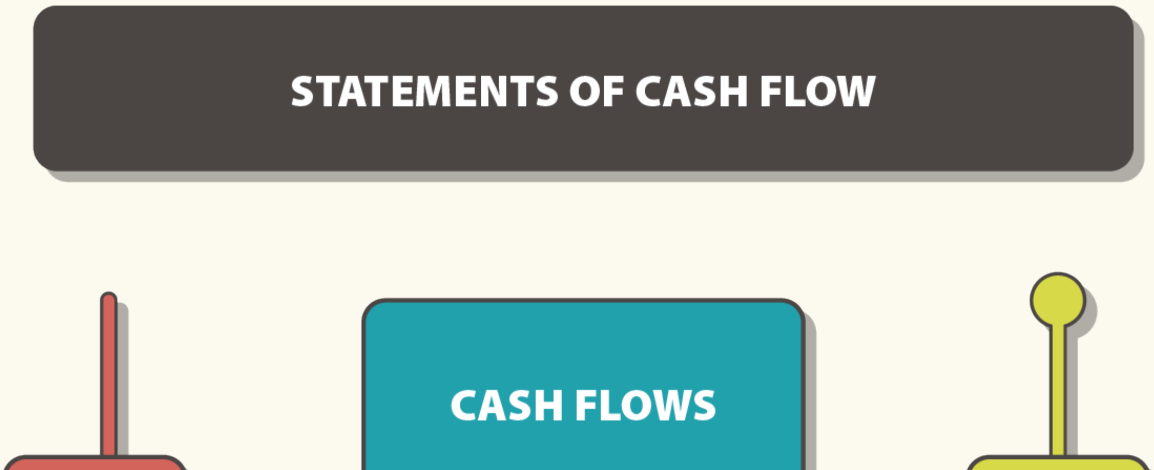
However, the main weakness of a statement of cash flow is that it is a historic statement. Therefore, it does not indicate whether the business will be able to meet its debts in the future. A more helpful statement would be a forecast statement of cash flow.

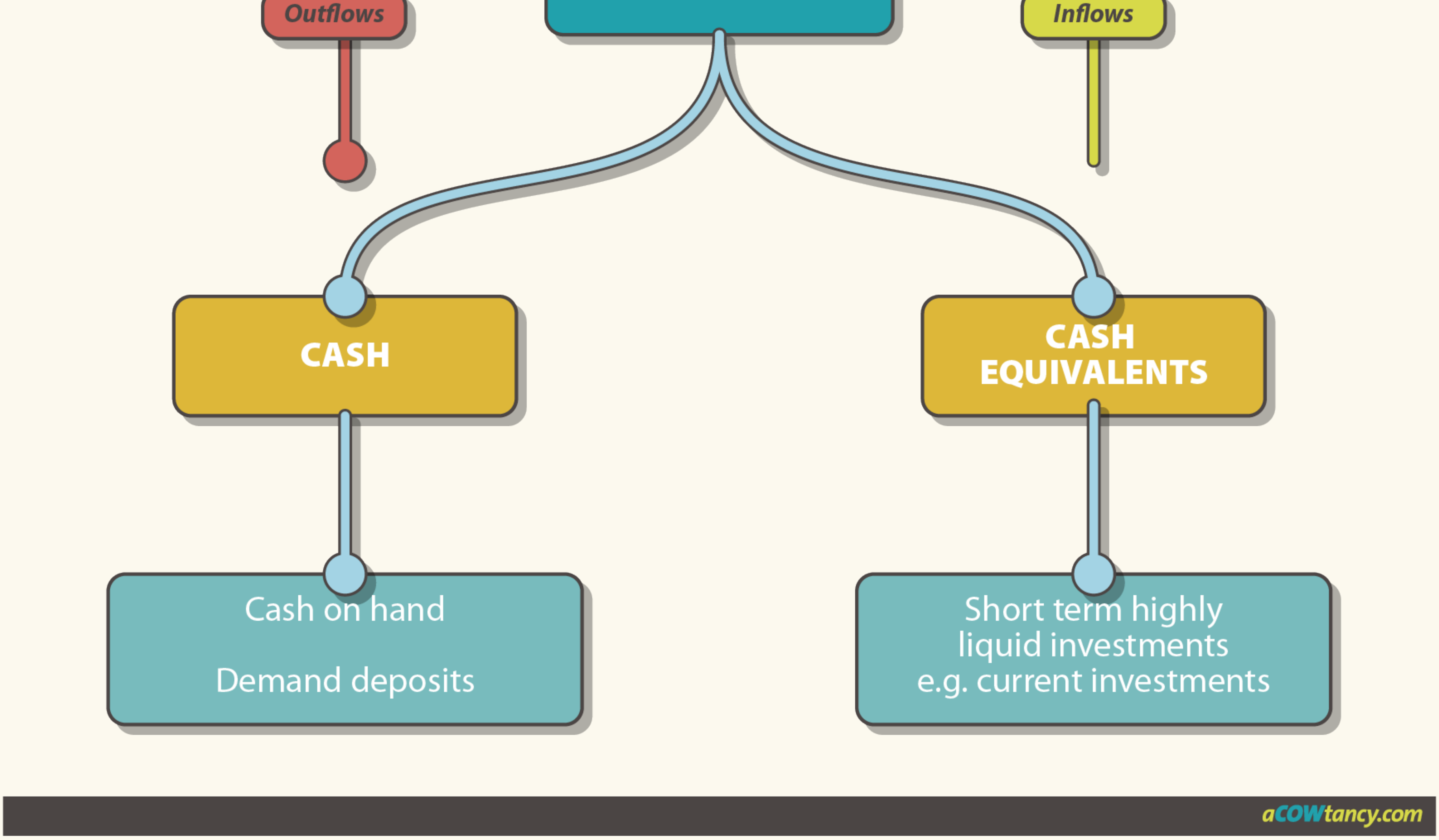
The effect of transactions on cash flows

IAS 7, Statements of Cash Flows

IAS 7, Statements of Cash Flows, splits cash flows into the following headings:

> Cash flows from operating activities
>
> Cash flows from investing activities
>
> Cash flows from financing activities





Cash flows from operating activities

These represent cash flows derived from operating or trading activities. There are two methods which can be used to find the net cash from operating activities: - direct and indirect method. These will be discussed in the next sections.

Cash flows from investing activities

These are related to the acquisition or disposal of any non-current assets or investments together with returns received in cash from investments, i.e. dividends and interest.

Cash flows from financing activities

Financing cash flows comprise receipts from or repayments to external providers of finance in respect of principal amounts of finance. For e.g.

1. Cash proceeds from issuing shares

2. Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short or long term borrowings
3. Cash repayments of amounts borrowed
4. Dividends paid to shareholders

In order to calculate such figures the closing statement of financial position figure for debt or share capital and share premium is compared with the opening position for the same items.

Statement of cash flows for the year ended 31 December 20X7 (INDIRECT METHOD)

	$000	$000
cash flows from operating activities		
profit before taxation	3390	
adjustment for:		
depreciation	450	
investment income	-500	
interest expense	400	

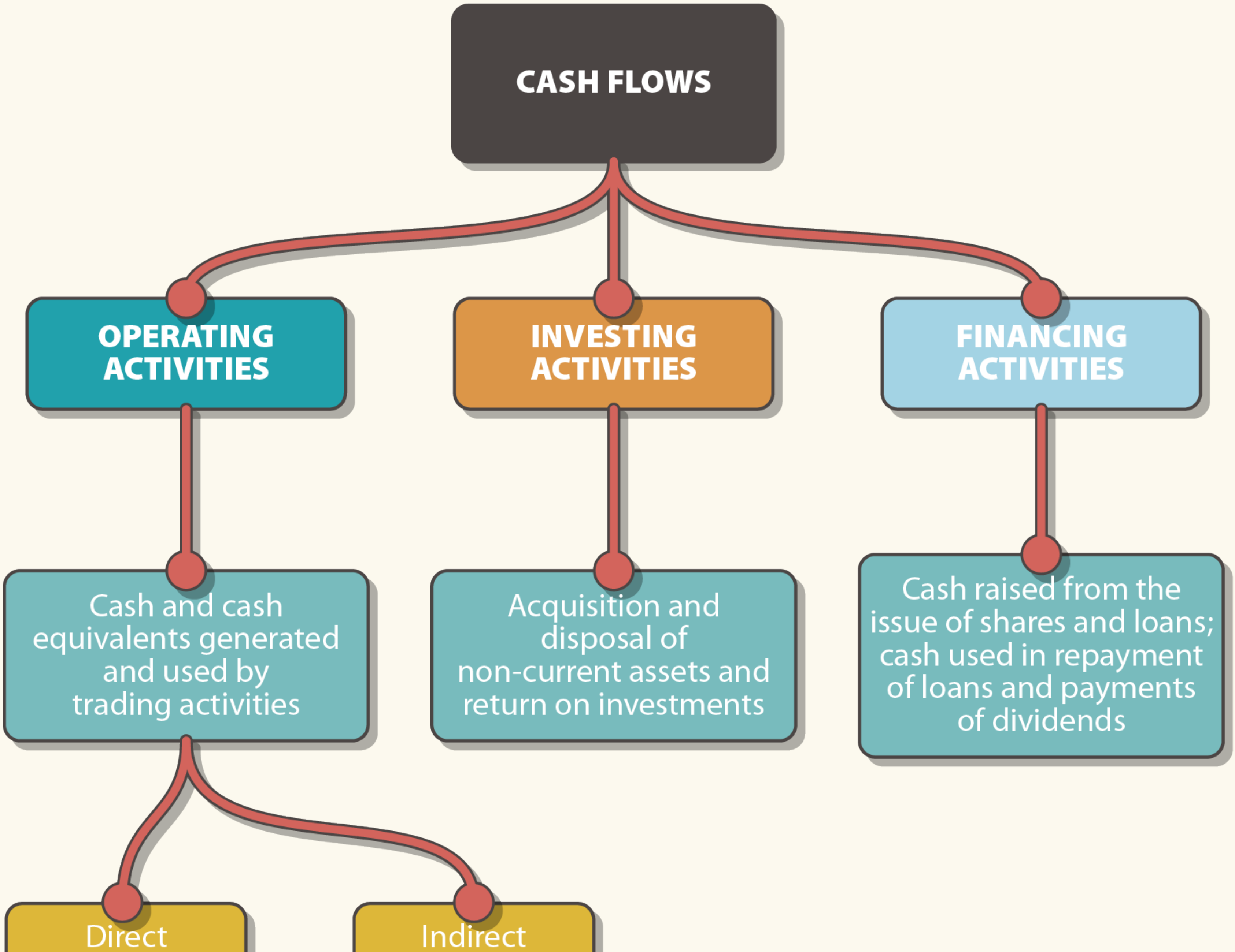
	3740	
increase in trade and other receivables	-500	
decrease in inventories	1050	

decrease in trade payables	-1740	
cash generated from operations	2550	
interest paid	-270	
income taxes paid	-900	
	------	
net cash from operating activities		1380
cash flows from investing activities		
purchase of property, plant and equipment	-900	
proceeds from sale of equipment	20	
interest received	200	
dividends received	200	
	------	
net cash used in investing activities		-480
cash flows from financing activities		
proceeds from issue of share capital	250	
proceeds from long-term borrowings	250	
dividends paid*	-1290	
	------	
net cash used in financing activities		-790
		------
net increase in cash and cash equivalents		110

cash and cash equivalents at beginning of period		120
		------
cash and cash equivalents at end of period		230
		------

* This could also be shown as an operating cash flow.

Calculate the figures needed



Method Method

Direct Method

In the direct method, the cash records of the business are analysed for the period, picking out all payments and receipts relating to operating activities. These are summarised to give the net figure for the cash flow statement. Not many businesses adopt this approach as it can be quite time consuming. However, this is the preferred method under IAS 7.

Statement of cash flows for the year ended 31 December 20x7 (DIRECT METHOD)

	$000	$000
cash flows from operating activities		
cash receipts from customers	30150	
cash payments to suppliers and employees	-27600	
	--------	
cash generated from operations	2550	
interest paid	-270	
income taxes paid	-900	
	--------	
net cash from operating activities		1380

Incomplete records

Incomplete records

Introduction

Incomplete records problems occur when a business does not have a full set of accounting records, for one of the following reasons.

The proprietor of the business does not keep a full set of accounts.

Some of the business accounts are accidentally lost or destroyed.

Accounting equation.

It is still possible to calculate a profit or loss figure by using the fact that the profit of a business must be represented by more assets. We list and value the opening and closing net assets, then calculate the profit as the difference between the two

Profit = Closing net assets - Opening net assets

Allowance must be made for proprietor's drawings and extra capital introduced, so the formula becomes:

Profit = Closing net assets - Opening net assets + Drawings - Capital introduced

Calculate missing figures

Control Accounts

A receivables ledger control account can be prepared to calculate missing credit sales. However, the figures for the opening and closing receivables of a business and the cash received from customers must be given.

RECEIVABLES LEDGER CONTROL A/C

Opening Balance	$38,600	Cash Received	$218,650
Sales (Balancing Figure)	$221,250	Closing Balance	$41,200
TOTAL	**$259,850**	**TOTAL**	**$259,850**

aCOWtancy.com

The same technique can be used to calculate credit purchases. A payables ledger control account can be prepared using given figures for opening and closing payables and cash paid.

Note

Total sales = Cash sales + Credit sales

Total sales = Cash sales + Credit sales

Total purchases = Cash purchases + Credit purchases

Cash/Bank

A cash account may need to be set up to find the figure missing for proprietor's drawings or cash stolen. Details of cash receipts and payments plus details of opening and closing balances must be given

Cost Structure

Margin: gross profit is expressed as a percentage of sales

For example a margin of 25% gives:

Sales 100%
Cost of sales 75%
Gross profit 25%

Mark-up: gross profit is expressed as a percentage of cost of sales

For example a mark-up of 35% gives:

Sales 135%
Cost of sales 100%
Gross profit 35%

Cost of sales = opening inventories + purchases – closing inventories

Goods Drawn By Proprietor

The owners of the business may at times take goods or cash from the business for their own use. This is known as drawings.

Cash Drawings

Dr Drawings

Cr Cash

Goods taken for own use

Dr Drawings
Cr Purchases

These are recorded at the cost to the business not at selling price. They are taken out of purchases and not recorded against inventories

Goods destroyed, stolen or lost

When inventory is stolen, destroyed or otherwise lost, the loss must be accounted for depending on whether or not these goods were insured against the loss.

If the lost goods were not insured,

Debit expense (e.g. admin expenses in the I/S)
Credit cost of sales

If the lost goods were insured,

Debit insurance claim account (current asset in SFP)
Credit cost of sales

Financial Statements for Companies

Introduction.

IAS 1 (revised) "Presentation of Financial Statements" prescribes the basis for presentation of general purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. It sets out overall requirements for the presentation of financial statements, guidelines for their structure and minimum requirements for their content.

A complete set of financial statements comprises

1. a statement of financial position as at the end of the period;
2. a statement of comprehensive income for the period;
3. a statement of changes in equity for the period;
4. a statement of cash flows for the period;
5. notes, comprising a summary of significant accounting policies and other explanatory information; and
6. a statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

An entity shall present a complete set of financial statements (including comparative information) at least annually.

Statement of profit or loss and other comprehensive income

One of the statements introduced by IAS 1 (revised) is the statement of comprehensive income. This statement presents all items of income and expense recognized in profit or loss together with all other items recognized in income and expense. Entities may present all items together in a single statement or present two linked statements – one displaying the items of income and expense recognised in the statement of profit or loss and the other statement beginning with profit or loss and displaying all the items included in 'other comprehensive income'.

Therefore, whereas the statement of profit or loss includes all realised gains and losses (e.g. net profit for the year), the statement of comprehensive income would include both the realised and unrealised gains and losses (e.g. revaluation surplus).

Proforma 1: One single statement

Statement of comprehensive income for the year ended 31 March 20X8

	20x8	20x7
	$'000	$'000
revenue	x	x
cost of sales	(x)	(x)
	------	------
gross profit	x	x
other income	x	x
distribution costs	(x)	(x)
administrative expenses	(x)	(x)
finance costs	(x)	(x)
investment income	x	x
	------	------
profit before tax	x	x
income tax expense	(x)	(x)
	-----	-----
profit for the year	x	x
other comprehensive income:		
gains on property revaluation	x	x
	-----	-----
total comprehensive income for the year	x	x
	====	====

Proforma 2: Two separate statements

Statement of profit or loss for the year ended 31 March 20X8

	20x8	20x7
	$'000	$'000
revenue	x	x
cost of sales	(x)	(x)
	------	------
gross profit	x	x
other income	x	x
distribution costs	(x)	(x)
administrative expenses	(x)	(x)
finance costs	(x)	(x)
investment income	x	x
	------	------
profit before tax	x	x
income tax expense	(x)	(x)

	-----	-----
profit for the year	**x**	**x**
	====	====

Statement of comprehensive income for the year ended 31 March 20X8

	20x8	20x7
	$'000	**$'000**
profit before tax	**x**	**x**
income tax expense	**(x)**	**(x)**
	-----	-----
profit for the year	**x**	**x**
other comprehensive income:		
gains on property revaluation	**x**	**x**
	-----	-----
total comprehensive income for the year	**x**	**x**
	====	====

Statements of financial position

Statement of financial position as at 31 March 20X8

	$'000
assets	
<u>non-current assets</u>	
property, plant and equipment	**x**
other intangible assets	**x**
	----
	x
<u>current assets</u>	
inventories	**x**
trade receivables	**x**
other current assets	**x**
cash and cash equivalents	**x**
	----
	x
	----
total assets	**x**
	===
equity and liabilities	

<u>equity</u>	
share capital	x
share premium account	x
revaluation reserve	x
retained earnings	x
	----
	x
<u>non-current liabilities</u>	
long term borrowings	x
long term provisions	x
<u>current liabilities</u>	
trade payables	x
short term borrowings	x
current tax payable	x
short term provisions	x
	----
total equity and liabilities	x
	===

Accounting Policies, Changes in Accounting Estimates and Errors

The provision of IFRS

The provision of IFRS governing financial statements regarding changes in accounting policies

IAS 8 prescribes criteria for selecting and changing accounting policies and also sets out the requirements for changes in accounting estimates and corrections of errors.

Accounting policies are specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. Once selected, accounting policies must be applied consistently for similar transactions, other events and conditions. They may be changed only if the change

> is required by a standard or an interpretation;
>
> results in financial statements providing reliable and or relevant information.

Accounting treatment

Appropriate accounting treatment if a company changes a material accounting policy.

A change in accounting policies must be applied retrospectively. That is to say, the new policy is applied to transactions, other events and conditions as if the policy had always been applied. The practical impact of this is that corresponding amounts (or "comparatives") presented in financial statements must be restated as if the new policy had always been applied. The impact of the new policy on the retained earnings prior to the earliest period presented should be adjusted against the opening balance of retained earnings.

Changes in accounting estimates are not examinable in the F3/FFA Paper

Material errors

Prior-period errors are omissions from, and misstatements in, financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that was available at the time and could reasonably be expected to have been obtained and taken into account in the preparation and presentation of financial statements. Misstatements or omissions are "material" if they could, either individually or cumulatively, influence the decisions of

users of financial statements.

Discovery of material errors relating to prior periods shall be corrected by restating comparative figures in the financial statements for the year in which the error is discovered.

Preparing simple consolidated financial statements

Subsidiaries

Terms

Group accounting

Parent

An entity that has one or more subsidiaries

Subsidiary

An entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).

Control

The power to govern the financial and operating policies of an entity so as to obtain benefits from its activities

Consolidated or group financial statements

The financial statements of a group presented as those of a single economic entity.

Non-controlling interest

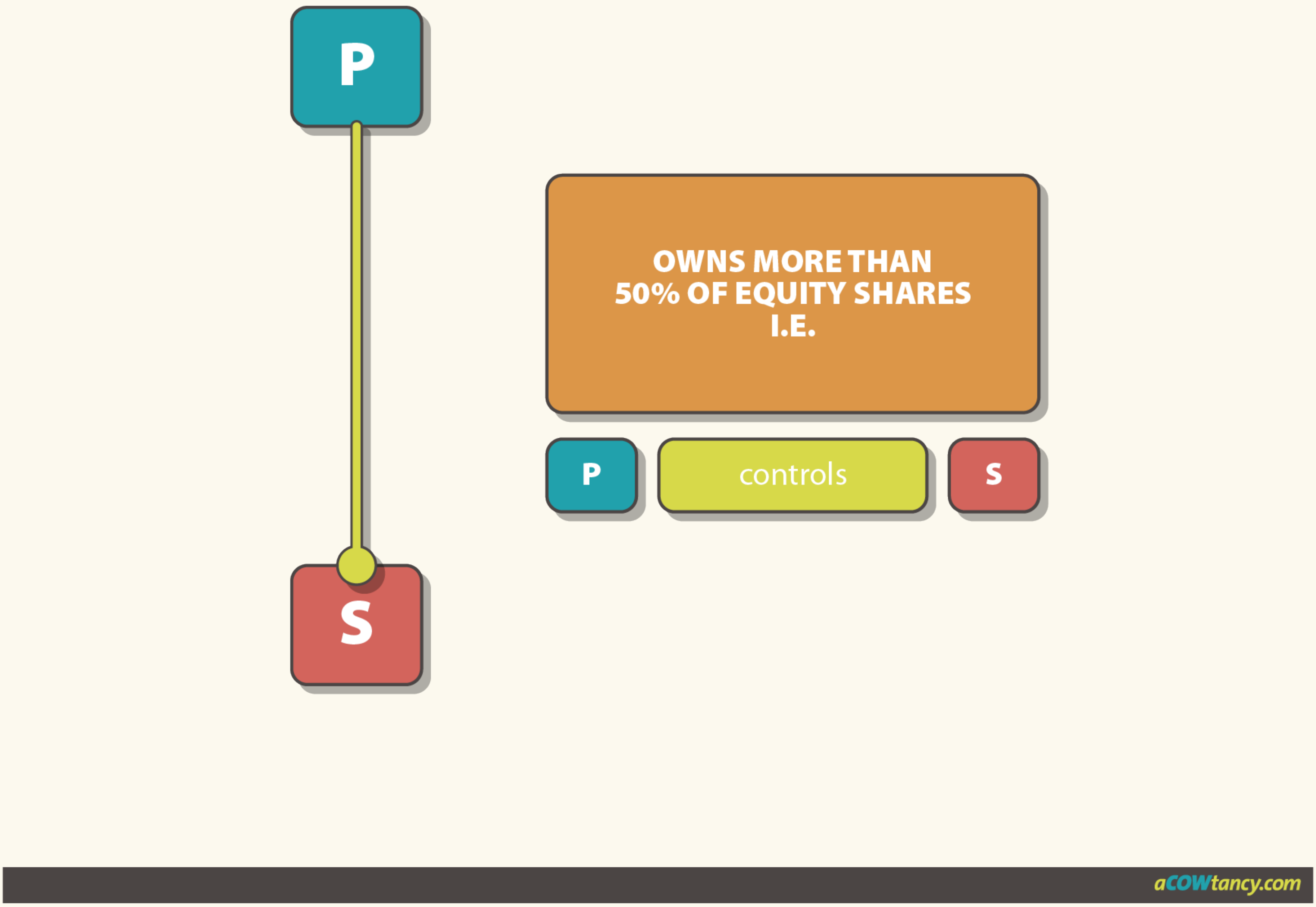
Non-controlling interest (NCI) arises when the parent entity controls a subsidiary but does not own 100% of it; e.g. if P owns only 70% of the ordinary shares of S, there is a NCI of 30%

Trade/simple investment

An investment in the shares of another entity, that is held for the accretion of wealth, and is not an associate or a

subsidiary. Trade investments are shown as investments under non-current assets in the consolidated SFP of the group.

Group structure



Subsidiary within a group structure

P is an individual legal entity, known as the parent. The parent is an entity that has one or more subsidiaries.

S is an individual legal entity, known as the subsidiary.

P owns more than 50% of the ordinary shares of S. It has enough voting power to appoint all the directors of S. P has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Although P and S remain distinct, in economic substance, they can be regarded as a single unit, the group.

Although control is usually based on ownership of more than 50% of voting power, IAS 27 lists the following situations where control exists, even when the parent owns only 50% or less of the voting power of an enterprise.

1. The parent has power over more than 50% of the voting rights by virtue of agreement with other investors
2. The parent has power to govern the financial and operating policies of the enterprise by statute or under an agreement
3. The parent has the power to appoint or remove a majority of members of the board of directors (or equivalent governing body)
4. The parent has power to cast a majority of votes at meetings of the board of directors

Consolidated financial statements present the results of the group; they do not replace the financial statements of the individual group companies.

Preparing a consolidated SFP.

Consolidated SFP

1. Take the individual accounts of the parent and subsidiary and cancel out items which appear as an asset in one company and a liability in another, e.g. receivables in one company and payables in another.
2. Add together all the uncancelled assets and liabilities throughout the group on a line by line basis.
3. The investment in the subsidiary (S) shown in the parent's (P) statement of financial position is replaced by the net assets of S.

The consolidated statement of financial position shows

The net assets of the whole group (P + S)

The share capital of the group which always equals the share capital of P only and

The retained profits, comprising profits made by the group (i.e. all of P's historical profits + profits made by S post-acquisition)

acquisition).

Goodwill

The value of a company will normally exceed the value of its net assets. The difference is goodwill. This goodwill represents assets not shown in the statement of financial position of the acquired company such as the reputation of the business and the loyalty of staff.

Value of the subsidiary

Where less than 100% of the subsidiary is acquired, the value of the subsidiary comprises two elements:

> The value of the part acquired by the parent;
>
> The value of the part not acquired by the parent, known as the non-controlling interest.

Positive goodwill

1. An intangible non-current asset in the SFP
2. Tested annually for impairment (amortisation of goodwill is not permitted). Impairment of goodwill is not examinable for F3 purposes

Negative goodwill

1. Arises where the cost of the investment is less that the value of net assets purchased.
2. Negative goodwill is credited directly to the statement of profit or loss.

Although there are two methods in which goodwill may be calculated following the update to IFRS 3, only the full goodwill method is examined in F3.

Non-controlling interest (NCI)

Fair value of non-controlling interest method (Full Goodwill)

This results in 100% of the goodwill being shown in the group statement of financial position – that belonging to the shareholders of the parent and that belonging to the non-controlling interest.

As mentioned above, a parent may not own all of the shares in the subsidiary, e.g. if P owns only 70% of the ordinary shares of S, there is a non-controlling interest of 30%.

Accounting treatment

In the consolidated statement of financial position, include all of the net assets of S

Transfer back the net assets of S which belong to the non-controlling interest within the capital and reserves section of the consolidated statement of financial position. A proportion of goodwill on acquisition is also transferred back to the NCI.

Pre- and Post-Acquisition Profits

Pre-acquisition profits are the reserves which exist in a subsidiary company at the date when it is acquired.

These are included in the goodwill calculation.

Post-acquisition profits are profits made and included in the retained earnings of the subsidiary company since acquisition.

They are included in group reserves.

Only the group share of the post-acquisition reserves of S is included in the group statement of financial position, i.e.

the reserves of S which arose after acquisition by P.

N.B. Where the acquisition occurs during the financial year, it is important to calculate the value of profits at the date of acquisition using time-apportionment,

Fair Value of Assets and Liabilities

The fair value of assets and liabilities is defined in IFRS 3 as 'the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction'.

IFRS 3 requires that the subsidiary's assets and liabilities are recorded at their fair value for the purposes of the calculation of goodwill and production of consolidated accounts.

Adjustment required

Adjustments will therefore be required where the subsidiary's accounts themselves do not reflect fair value.

1. Adjust both columns of the net assets calculation to bring the net assets to fair value at acquisition and reporting date.
2. At the reporting date, make the adjustment on the face of the SFP when adding across assets and liabilities.

Share for share exchanges.

Share for share exchanges form part, or all, of the cost of investment which is used in the goodwill calculation.

If this exchange has yet to be accounted for, the double entry is always: -

Dr Cost of Investment
Cr Share capital (with the nominal value of P shares given out)
Cr Share premium (with the premium

Intra Group Balances

If the companies within the same group trade with each other, then this will probably lead to:

• A receivables account in one company's SFP

• A payables account in the other company's SFP.

These are amounts owing within the group rather than outside the group and therefore they must not appear in the consolidated statement of financial position. They are therefore cancelled against each other on consolidation.

Unrealised Profit.

Unrealised profit may arise within a group scenario on

1. Inventory where companies trade with each other
2. Non-current assets where one company has transferred an asset to the other company within the same group.

Adjustment for unrealised profit in inventory

Determine the value of closing inventory which has been purchased from the other company in the group.

Use mark-up or margin to calculate how much of that value represents profit earned by the selling company.

Make the adjustments according to who the seller is

If the seller is the parent company:

Dr Group retained earnings

Cr Group inventory (deduct the profit when adding P's inventory + S's inventory on the face of the consolidated SFP).

If the seller is the subsidiary:

Dr Subsidiary retained earnings

Dr Subsidiary retained earnings

Cr Group inventory (deduct the profit when adding P's inventory + S's inventory on the face of the consolidated SFP).

Adjustment for unrealised profit in the transfer of non-current assets

Occasionally, a non-current asset is transferred within the group (say from a parent to a subsidiary). The parent may have manufactured the asset as part of its normal production (and therefore included the sale in revenue), or it may have transferred an asset previously used as part of its own non-current assets. If the transfer is done at cost, then, in the first case, the cost of the asset must be removed from both revenue and cost of sales. In the second case, no elimination would be required.
If one company sells non-current assets to another company in the same group at a profit, adjustments must be made for:

1. Profit on sale
2. Depreciation

The whole scenario has to be recreated as if the sales have never occurred.

carrying value at reporting date	**x**
carrying value at reporting date if intra-group transfer had not occurred	**x**
	---
adjustment	**x**
	==

The double-entry of this adjustment is: -

Dr Retained Earnings of the seller

Cr Non-Current Assets (P’s NCA + S’s NCA – Adjustment for UP)

Consolidated statement of comprehensive income.

Basic principles

> From sales revenue to profit after tax, include all of P’s income and expenses plus all of S’s income and expenses (where a mid-year acquisition has occurred, these must be time-apportioned).
>
> Once the profit after tax is calculated, deduct share profits due to the non-controlling interest.

Non-controlling interest

This is calculated as: NCI% x subsidiary’s profit after tax (taken from S’s column of consolidation schedule).

Dividends

A payment of a dividend by S to P must be cancelled. Any dividend income shown in the consolidated statement of profit or loss must arise from investments other than those in subsidiaries or associates.

Unrealised Profits

The adjustment to unrealised profit should be shown as an increase to cost of sales. It affects the books of the SELLER.

Sales and Purchases

Intra-group trading must be eliminated from the consolidated statement of profit or loss.

Consolidated sales revenue = P's revenue + S's revenue – intra-group sales

Consolidated cost of sales = P's COS + S's COS – intra-group sales

Interest on loan

If loans are outstanding between group companies, intra-group loan interest will be paid and received. Both the loan and loan interest must be excluded from the consolidated results.

Transfers of non-current assets

If one group company sells a non-current asset to another group company, the following adjustments are needed in the statement of profit or loss

> Any profit or loss arising on the transfer must be deducted
>
> The depreciation charge must be adjusted so that it is based on the cost of the asset to the group

Mid-year acquisitions

If a subsidiary is acquired part way through the year, then it is important to time apportion the results of S in the year of acquisition. Unless indicated otherwise, assume that revenue and expenses accrue evenly.

Other Comprehensive Income

The consolidated statement of comprehensive income is produced using the consolidated statement of profit or loss as a basis. Remember that in F3/FFA, the only item of other comprehensive income you may have is the revaluation of PPE. This is shared between the owners of the parent and NCI according to the percentage of their investment.

Associates.

Definition Associate

IAS 28 defines an associate as

An entity over which the investor has significant influence but not control or joint control and that is neither a subsidiary nor an interest in joint venture.

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not in control or joint control over those policies.

There are several indicators of significant influence, but the most important are usually considered to be a holding of between 20% and 50% of the voting shares and board representation.

The existence of significant influence by an investor is usually evidenced in one or more of the following ways:

> representation on the board of directors or equivalent governing body of the investee
>
> participation in the policy-making process
>
> material transactions between the investor and the investee
>
> interchange of managerial personnel
>
> provision of essential technical information

Equity accounting

Equity accounting brings an associate investment into the parent company's financial statements initially at cost.

The basic principle of equity accounting is that P Co should take account of its share of the earnings of A Co whether or not A Co distributes the earnings as dividends. A's sales revenue, cost of sales, expenses and revenue are not added with those of the group. Instead the group share only of A's profit after tax is included in the consolidated statement of profit or loss as a single amount.

P Co should also include its share of A Co's other comprehensive income in its consolidated statement of comprehensive income.

In the consolidated statement of financial position, the associate is included as a non-current asset investment, calculated as

	$'000
cost of investment	x
p’s share of post acquisition profits of a	x
less: impairment losses of a	x
	---
	x
	==

Interpretation of financial statements

Importance and purpose of analysis of financial statements

Interpretation of ratios

The financial statements of a business provide important financial information for people outside the business (external users) who do not have access to the internal accounts. For example, current and potential shareholders can see how much profit a business made, the value of its assets and the level of cash reserves.

Although these figures are useful, they do not mean a great deal by themselves. To summarise and present financial information in a more understandable form, they need to be properly analysed using accounting ratios and then compared with either the previous year’s ratios or against averages for the industry.

The lack of detailed information available to the external user is a considerable disadvantage in undertaking ratio analysis. There may simply be insufficient data to calculate all of the required ratios.

Comparisons with previous year’s ratios can be difficult especially if there have been changes in accounting policies or in the nature of the business. Comparability between companies may be impaired due to different accounting policies and different environments in which the two companies are operating.

Ratios and analysis

Profitability Ratios

Return on Capital Employed (ROCE)

A business buys assets such as trucks, computers, etc to help makes its operations more efficient, cut down on costs and make bigger profits.

ROCE shows how well a business has generated profit from its long-term financing.

It is expressed in the form of a percentage, and the higher the percentage, the better.

ROCE is calculated either:

Profit Before Interest and Tax

Total Assets – Current Liabilities (Capital Employed)

OR
Profit before Interest and Tax

Shareholder’s Equity + long-term liabilities

How can firms increase the ROCE ratio?

Movements in return on capital employed are best interpreted by examining profit margins and asset turnover (in more detail below) as ROCE is made up of these component parts.

Firms can increase their ROCE ratio by:

- Cutting costs so as to increase the profit margin ratio
- Increasing the revenue made from their assets, i.e. more efficient use of assets

Limitations of using ROCE ratio

Be careful when using the ROCE ratio because it does not always yield the correct percentage.

For instance, a company may simply run down its old assets. This means the denominator "Total Assets – Current Liabilities" (value of assets is lower) will be lower and so give a higher ROCE percentage.

In this case, there has been no improvement in operations of the company, in fact the firm is cutting down on potentially profitable capital investments.

Note

Always compare a company's ROCE to the interest rate it is charged. The ROCE needs to be higher.

Similarly if a company pays off a 5% loan, while its current ROCE is 10%, then this is illogical. It should use the money to get 10% not pay off a loan which only costs 5%.

Asset Turnover

Asset turnover shows how efficiently management have utilised assets to generate revenue.

It is calculated as

Revenue

Total assets – current liabilities

When looking at the components of the ratio, a change will be linked to either a movement in revenue, a movement in net assets, or both.

An increase in asset turnover can result from

- a significant increase in sales revenue
- the business entering into a sale and operating lease agreement, then the asset base would become smaller, thus improving the result.

Return on Equity (ROE)

The ROE ratio reveals how much profit has been made in comparison to shareholder equity.

A business that has a high return on equity is more likely to be one that is capable of generating cash internally.

Profit after tax – preference dividends
--
Equity shareholders funds

Gross Profit Margin

The gross profit margin looks at the performance of the business at the direct trading level.

Gross profit

Revenue

Variations in the Gross Profit Margin are as a result of:

1. changes in the selling price/sales volume
2. changes in cost of sales.

For example, cost of sales may include inventory write downs that may have occurred during the period due to damage or obsolescence, exchange rate fluctuations or import duties.

Net Profit Margin

The net profit margin is generally calculated by comparing the profit before interest and tax of a business to revenue.

Profit before interest and tax

Revenue

However, the examiner may specifically request the calculation to include profit before tax.

Analysing the net profit margin enables you to determine how well the business has managed to control its indirect costs during the period. In the exam, when interpreting operating profit margin, it is advisable to link the result back to the gross profit margin.

For example, if gross profit margin deteriorated in the year then it would be expected that the net profit margin would also fall. However, if this is not the case, or the fall is not so severe, it may be due to good indirect cost control or perhaps there could be a one-off profit on disposal distorting the operating profit figure.

It is important to note that the profit margin and asset turnover together explain the ROCE.

Profit Margin x Asset Turnover = ROCE

PBIT x Sales = PBIT

------ ---------------- --------------------
Sales Capital Employed Capital Employed

Liquidity Ratios.

Current Ratio

Current Assets

Current Liabilities

The current ratio considers how well a business can cover the current liabilities with its current assets. It is a common belief that the ideal for this ratio is between 1.5 and 2 : 1 so that a business may comfortably cover its current liabilities should they fall due.

However this ideal should be considered in the context of the company: the nature of the assets in question, the company's ability to borrow further to meet liabilities and the stability of its cash flows.

For example, a business in the service industry would have little or no inventory and therefore could have a current ratio of less than 1. This does not necessarily mean that it has liquidity problems so it is better to compare the result to previous years or industry averages.

Quick Ratio

Current Assets – Inventories

Current Liabilities

One of the problems with the current assets ratio is that the assets counted include inventories which may or may not be quickly sellable (or which may only be sellable quickly at a lower price).

The ideal ratio is thought to be 1:1, but as with the current ratio, this will vary depending on the industry in which the business operates.

The quick ratio is also known as the acid test ratio. This name is used because it is the most demanding of the commonly used tests of short term financial stability.
When assessing both the current and the quick ratios, remember that both of these ratios can be too high. This would mean too much cash is being tied up in current assets as opposed to new more profitable investments.

It is important to look at the information provided within the question to consider whether or not the company has an overdraft at year-end. The overdraft is an additional factor indicating potential liquidity problems and this form of finance is both expensive (higher rates of interest) and risky (repayable on demand)

Efficiency Ratios.

Inventory Turnover Period

Closing (or average) Inventory x 365

COS

This ratio calculates how long goods to be sold stay in stock.

Generally, the lower the number of days that inventory is held the better as holding inventory for long periods of time constrains cash flow and increases the risk associated with holding the inventory. The longer inventory is held the greater the risk that it could be subject to theft, damage or obsolescence. However, a business should always ensure that there is sufficient inventory to meet the demand of its customers.

Receivables Collection Period (in days)

Trade Receivables x 365

Credit Sales

This ratio calculates how long credit customers take to pay.

A short credit period for receivables will aid a business' cash flow. However, some businesses base their strategy on long credit periods to achieve higher sales in highly competitive markets.

If the receivables days are shorter compared to the prior period, it could indicate better credit control or potential settlement discounts being offered to collect cash more quickly whereas an increase in credit periods could indicate a deterioration in credit control or potential bad debts

Payables Payment Period (in days)

Trade Payables x 365

Credit Purchases

This ratio calculates how long the company takes to pay its suppliers.

An increase in payables days could indicate that a business is having cash flow difficulties and is therefore delaying payments. It is important that a business pays within the agreed credit period to avoid conflict with suppliers.

If the payables days are reducing, this indicates suppliers are being paid more quickly. This could be due to credit terms being tightened or taking advantage of early settlement discounts being offered.

Working Capital Cycle (cash cycle)

A company only gets cash once an item has been in stock and then the debtor pays (Inventory days + receivables days).

This total should then be reduced by the payable days (the company doesn't need the cash until the end of this).

So, the working capital cycle (in days) is:

Inventory (in days) + Receivables (in days) – Payables (in days)

This needs to be kept as small as possible for liquidity purposes.

Debt and Gearing Ratios

Debt Ratio

Total debts

Total assets

Assets = non-current assets + current assets

Debts include all payables, whether they are due within one year or after more than one year.

Gearing

A company can raise money by loans (Debt) or issuing shares (Equity).

Gearing can be calculated either:

Debt

Debt + Equity

OR
Debt

Equity

The gearing ratio is of particular importance to a business as it indicates how risky a business is perceived to be based on its level of borrowing.

High gearing means high debt (in relation to equity). As borrowing increases so does the risk as the business is now liable to not only repay the debt but meet any interest commitments under it. If interest rates increase, then the company could be in trouble unless they have high enough profits to cover this. In addition, to raise further debt finance could potentially be more difficult and more expensive.

Leverage (equity to sales ratio)

Leverage is the converse of gearing, i.e. the proportion of total assets financed by equity.

Shareholder's equity x 100

Shareholders' equity + total long term debt

OR
Shareholder's equity x 100

Total assets less current liabilities

Interest Cover

If a company has a high level of gearing it does not necessarily mean that it will face difficulties as a result of this.

For example, if the business has a high level of security in the form of tangible non-current assets and can comfortably cover its interest payments, a high level of gearing should not give an investor cause for concern.

The interest cover is calculated:

Profit before Interest and Tax (PBIT)

Interest payable

A ratio of at least 3 is deemed to be satisfactory.
The interest coverage ratio is a measurement of the number of times a company could make its interest payments with its earnings.

It is the equivalent of a person taking the combined interest expense from their mortgage, credit cards etc, and calculating the number of times they can pay it with their annual income.

PBIT has its short-fallings; companies do pay taxes, therefore it is misleading to act as if they didn't. A wise and

PBIT has its short failings; companies do pay taxes, therefore it is misleading to act as if they didn't. A wise and conservative investor would simply take the company's earnings before interest and divide it by the interest expense. This would provide a more accurate picture of safety.